

GROCERIES MARKET INVESTIGATION

Emerging Thinking

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23 January 2007

Introduction

1. This document sets out our emerging thinking on competition in the supply of groceries¹ by retailers in the UK on the basis of the evidence we have analysed to date. It identifies areas where we are seeking additional evidence and the issues on which we expect to concentrate our attention in the period prior to the planned publication of our provisional findings in June 2007.
2. We have not reached any conclusions on the issues that have arisen in this investigation and are discussed in this document. Our thinking, however, is further advanced in some areas than in others. The areas where we have significant further work to do, such as our analysis of competition between grocery retailers in local areas, are identified in this document. The purpose of this document is to expose the direction of our thinking and to elicit further evidence from parties in relation to these matters.
3. We are publishing at the same time as this document eight working papers which address a number of the issues discussed in this document in greater detail. These working papers similarly represent our views on the basis of the evidence we have seen to date. Again, we invite comments and further evidence from parties in relation to the matters covered in these working papers. We are also publishing at the same time as this document the results of a survey of suppliers to UK grocery retailers conducted on behalf of the CC by GfK in late 2006.

¹'Groceries' is defined in our terms of reference as: including food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods; and excluding petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers, magazines, greetings cards, CDs, DVDs, videos and audio tapes, toys, plants, flowers, perfumes, cosmetics, electrical appliances, kitchen hardware, gardening equipment, books, tobacco and tobacco products.

Background

4. The Office of Fair Trading (OFT) referred the supply of groceries by retailers in the UK to the Competition Commission (CC) for investigation under section 131 of the Enterprise Act 2002 (the Act) on 9 May 2006. The reference followed an initial OFT study into the sector and public consultation. Our terms of reference are set out in Appendix A.

5. Our inquiry into the supply of groceries is a market investigation under the Act. Section 134(2) of the Act requires us to consider whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK'. The presence of one or more 'features', which would represent an adverse effect on competition, may refer to:
 - (a) the structure of the market concerned or any aspect of that structure;
 - (b) any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or
 - (c) any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.

6. If the CC decides that there is an adverse effect on competition, it is required under section 134(4) of the Act to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers² so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and, if so, what action should be taken.

²A detrimental effect on customers is defined in section 134(5) of the Act as taking the form of: (a) high prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or (b) less innovation in relation to such goods or services.

7. The investigation has, to date, attracted considerable interest and we have received a significant volume of evidence from a variety of parties in the form of both written submissions and oral hearings. We have conducted site visits to seven grocery retailers and a grocery wholesaler, and have held hearings with 49 parties including hearings in Scotland, Northern Ireland and Wales. We have also held two roundtables with academic economists in October 2006 to discuss local competition between grocery retailers and buyer power issues.³ We have published on our website the key views of those who have given evidence to us, subject to the statutory constraints placed upon us by the Act, including the need to protect the commercial and other interests of those giving evidence. As noted in paragraph 3, we have also published on our website the results of a supplier survey conducted on our behalf by GfK. As the inquiry progresses and we receive further evidence, we will continue to make this available, as far as is possible, through our website.

8. Our intention is to publish our provisional findings in June 2007. In the event that we need to consider remedies, this will take place in the second half of 2007 with our final report being published in November 2007. A more detailed timetable for the inquiry is published on our website.

Summary of current thinking

9. Since 2000, grocery sales have increased by nearly 17 per cent in real terms to an estimated total of £123.5 billion, while at the same time the real price of food has declined by around 7 per cent. This growth in sales has been seen at both supermarkets (26 per cent) and convenience stores (19 per cent). However, sales at specialist grocery stores, such as butchers and greengrocers, have only increased by 1 per cent in real terms over this period.

³Details of roundtable participants and a transcript of the discussion from each roundtable is available on the CC website.

10. While grocery sales have increased, the number of grocery outlets has declined, with the number of supermarkets, convenience stores and specialist grocery stores falling by 2 per cent, 8 per cent and 7 per cent respectively since 2000. Despite this, the number of stores operated by the four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco) has more than doubled since 2000 reflecting both the opening of new stores and the acquisition of competitors.

11. These overall trends (see paragraphs 30 to 55 for further details) provide the context for our investigation into the supply of groceries. Our issues statement, published on 15 June 2006, identifies three areas that we consider most important to our investigation: the behaviour of grocery retailers towards their suppliers; the conduct of grocery retailers and consumers as well as the structure of any local market for groceries; and land and planning issues. We summarize in paragraphs 12 to 29 our current thinking on these issues as well as our current thinking on the appropriate definition of the relevant market(s) for the supply of groceries. Further details of our thinking are provided in the remainder of this document and in the accompanying working papers. As set out in paragraph 2, our thinking on all of these issues remains preliminary.

Market definition

12. Our preliminary thinking in relation to the relevant product market(s) for the retail supply of groceries is that we consider larger grocery outlets to be an effective substitute for smaller grocery outlets, and as a result, these larger stores constrain the prices, and other non-price competitive variables, such as product quality, product range and service (together the 'retail offer') of smaller stores. However, we do not currently view smaller grocery outlets as providing a similarly effective substitute for larger grocery outlets. Further, it is not clear that consumers view the retail offers of different grocery retailers of the same size as equally substitutable.

Upmarket grocery retailers, such as Marks & Spencer (M&S), may be in a separate product market from Limited Assortment Discounters (LADs), such as Aldi.

13. In relation to the relevant geographic market, our current view, consistent with previous investigations, is that retail markets for the supply of groceries are, essentially, local. This view is based on factors such as consumer preferences, retailers' own assessments and localized marketing activities. We recognize, however, that there are arguments in favour of a national market, such as the national pricing and marketing activities of many grocery retailers.
14. Further details of our thinking on market definition are contained in paragraphs 85 to 98 as well as in our **working paper on market definition**. In the lead-up to the publication of our provisional findings we will undertake a detailed quantitative analysis that will assist us in determining appropriate product and geographic market boundaries.

Supply chain practices

15. We are investigating a number of ways in which the behaviour of grocery retailers towards their suppliers might be having an adverse impact on consumers. The evidence we have reviewed to this point is summarized in paragraphs 16 to 19.
16. There does not appear to be a systemic problem with the economic viability of suppliers immediately upstream from the grocery retailers (ie food and drink manufacturers and processors rather than primary producers). There is little sign of any ongoing decline in profits for these suppliers, as a group. In terms of primary producers, which are generally located one or two steps removed from grocery retailers in the supply chain, our analysis to this point has focused on dairy and pig-meat farming. This points towards grocery retailers earning an increasing share of

milk revenues compared with processors and farmers, but is less clear in relation to pig meat. Putting revenue shares to one side, Defra statistics indicate that the number of dairy and pig-meat farms has shrunk significantly, indicating that many individual farmers are likely to have suffered substantial difficulties in recent years. However, for those farms that have remained, average incomes, although not necessarily returns on capital, have increased in both sectors since 1999. Further details of our analysis are in paragraphs 103 to 110 and in the **working paper on supplier profitability**.

17. We have also looked at the economic viability of grocery wholesalers, which we have been told may be brought into question due to a combination of the buyer power of the supermarket chains and the closure of convenience stores. The evidence we have reviewed so far, however, does not indicate problems in terms of their economic viability as a group (see paragraphs 111 to 114 and the **working paper on wholesalers**).

18. We are investigating the extent to which suppliers charge higher prices to smaller grocery retailers to compensate for lower prices to larger grocery retailers (the so-called 'waterbed' effect) and the extent to which this may disadvantage consumers. Detailed pricing evidence we have reviewed from 15 suppliers of major branded products does not indicate that the larger grocery retailers systematically obtain lower prices from their suppliers than smaller grocery retailers or wholesalers. Our survey of suppliers, however, does point towards suppliers providing a better quality of service to larger grocery retailers than smaller grocery retailers. This might indicate a 'waterbed' effect in relation to non-price variables. Further details of our analysis are in paragraphs 115 to 117 as well as in the **working paper on buyer power**.

19. Concerns have also been raised with us regarding aspects of grocery retailers' behaviour towards their suppliers such as unilateral changes in trading terms and requirements for lump sum payments. Many suppliers, however, have been reluctant to provide us with details of specific instances to illustrate the general concerns that have been raised with us due to concerns of possible retaliation by grocery retailers. In the absence of more specific examples, we may find it difficult to come to any conclusion. We note that additional material has been submitted quite recently and we will review this in the coming weeks. However, we would encourage suppliers to come forward with further examples of particular problems they may have encountered. We are confident of our ability to address any concerns suppliers may have regarding issues of confidentiality. Further details of our analysis to date are contained in paragraphs 122 to 126 and in the **working paper on supply chain practices**.

Market structure and conduct

20. Regarding the structure of local markets and the conduct of grocery retailers, we will be looking closely in the next stage of our investigation at the extent to which product range and pricing in local areas is affected by the number and nature of different grocery retailers. A very preliminary analysis indicates that only 35 per cent of the urban population in the UK has a choice of at least three different grocery outlets larger than 1,400 sq metres within a 10-minute drive-time. If the drive-time is increased to 15 minutes, however, the proportion of the urban population within reach of three different grocery outlets larger than 1,400 sq metres increases to 80 per cent. The respective percentages in rural areas are less than 5 per cent for a 10-minute drive-time and 24 per cent for a 15-minute drive-time.
21. In the context of looking at the conduct of grocery retailers, we have reviewed grocery retailers' pricing practices focusing on below-cost selling and price flexing.

We have identified ten grocery retailers that engage in below-cost selling, although the extent of their below-cost selling is small in the context of their total revenues. Our current thinking is that predatory strategies towards smaller grocery retailers and specialist stores appear to be feasible in certain circumstances. We also consider that below-cost selling by larger grocery retailers may also unintentionally contribute to the exit of smaller grocery retailers and specialist stores.

22. In relation to price flexing (ie the practice of varying prices between stores), Asda, Morrisons, Sainsbury's and Tesco each have national price lists for goods but all adjust their offering at the local level. The value of these local adjustments is small in the context of total grocery revenues. A number of other grocery retailers, however, have told us that they set their store price according to the local level of competition. Further details of our analysis to date are contained in paragraphs 127 to 143 and the **working paper on pricing practices**.
23. The CC has previously found that high levels of concentration, high levels of price monitoring and stable demand in grocery retailing are conducive to the presence of coordinated effects.⁴ During this investigation, few parties have suggested that there is a problem with coordination between grocery retailers. However, we will be considering in the next stage of this investigation whether there is any evidence of tacit coordination between grocery retailers.

Planning and land use

24. In relation to planning, the nature and operation of the systems of planning controls in the various parts of the UK have, as may be expected, affected the size and location of grocery retail outlets. We have noted the Barker Review's opinion that super-

⁴*Safeway plc and Asda Group Limited; Wm Morrison Supermarkets plc; J Sainsbury plc; and Tesco plc: a report on the mergers in contemplation*, TSO, September 2003.

market development in England and Wales is being restrained by the retention of the so-called 'need' test. Although some individual cases have been brought to our attention, it is not clear to what extent they are evidence of systematic or widespread use by major retailers of the planning system to gain a competitive advantage, but we will be continuing to investigate this area in the lead-up to our provisional findings. Further details of our analysis are in paragraphs 150 to 160 and in the **working paper on planning issues**.

25. In relation to land, we have obtained substantial data on the land holdings and intentions of the major grocery retailers. An initial analysis confirms Tesco's pre-eminent position in terms of the holding of land for retail development. The suggestion that Tesco can build on its owned land to achieve a 45 per cent share of grocery retailing is not in our view, on present evidence, substantiated. We have carried out some initial analysis of the ways in which land holdings might be used to impede entry by competitors into local markets and will be taking this forward in the period leading up to provisional findings. Further details of our analysis to date are in paragraphs 161 to 169 and in the **working paper on land holdings and use issues**.

26. Other issues concerning the supply of groceries have also been brought to our attention in terms of environmental effects, changes affecting the UK agricultural industry and dietary health. We recognize that there may be costs to the community associated with these issues. The causes of these costs may include government policy choices, consumer preferences, or ineffective competition. We are giving careful consideration to all the issues that have been raised with us. In some cases, though, the evidence submitted to us bears on issues beyond competition, and we need to be sure we are acting within our statutory powers.

27. As consumers become more aware of costs that may be associated with current arrangements for the provision of groceries, they may choose to exercise their choice of product or grocery outlet in a way that better reflects a balance between access to cheap, convenient groceries in large quantities and other factors that they value. In a market where competition is effective, if consumers did exercise choice in this way, grocery retailers would have to follow and alter their offering, or lose customers, market share and profit. We set out these issues more fully in paragraphs 74 to 84.
28. Finally, it seems to us that what underlies many of the issues that have been raised is a general concern that the position of the major grocery retailers, individually and collectively, is so strong that it is distorting competition to an unacceptable degree. This concern often focuses on one major grocery retailer in particular on account of its national share of grocery retailing, holdings of land for development, ubiquity of operations and extension into non-grocery retailing. Given the strength of feeling that the activities of this particular retailer appear to generate, we think it best that we bring all of the relevant issues out into the open so that they can be considered fairly and objectively.
29. Our starting point is that in a competitive market, commercial success should not be penalized unless there is clear evidence of an abuse of market power and harm to consumers. We also do not necessarily attach particular significance, in the context of competition between retailers, to the national share of any one grocery retailer, although we have not come to a final view on the relevant geographic market and we do see national shares as relevant to the assessment of buyer power. However, we will look closely at the implications of any significant local pre-eminence in the context of our detailed investigation of competition between retailers. Moreover, while the achievement of market power by successful commercial means is not in itself harmful, we will wish to consider very carefully whether, taking account of likely future

trends, the grocery market is sufficiently competitive to prevent any one grocery retailer's pre-eminent position, however acquired, becoming entrenched and incontestable by others.

Overview of the groceries sector

30. Retail sales of groceries in the UK amounted to £123.5 billion in 2006⁵ (approximately 16 per cent of total consumer expenditure in the UK), an increase of approximately 16.8 per cent in real terms since 2000. During this period, real prices for food declined by 7.3 per cent⁶ and the number of product lines supplied by the four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco) increased by 40 per cent.⁷
31. The following paragraphs provide an overview of UK grocery retailing and wholesaling as well as grocery suppliers and consumers, and discuss significant developments since the CC's investigation into supermarkets in 1999/2000.⁸ The material in this section is drawn from a range of industry publications as well as the submissions of grocery retailers, wholesalers and suppliers.⁹

Grocery retailers

32. In 2006, approximately 72 per cent of grocery sales took place in supermarkets, 20 per cent in convenience stores¹⁰ and the remaining 8 per cent in other outlets, including specialist grocery stores.¹¹ This compares with 67 per cent from

⁵IGD, *UK Grocery Retailing*, 2006.

⁶We note, however, that *The Grocer* magazine estimates food price inflation of 5.1 per cent for the past 12 months (*The Grocer*, 13 January 2007, p7), which would imply an increase in real food prices over this period.

⁷OFT, *The grocery market: the OFT's reasons for making a reference to the Competition Commission*, May 2006, p24.

⁸*Supermarkets: a report on the supply of groceries from multiple stores in the UK*, TSO, October 2000.

⁹Further details of the grocery industry and related developments can be found in a variety of publications including: IGD, *UK Grocery Retailing*, various years; Verdict, *Neighbourhood retailing*, 2006; Mintel, *Non-foods in Grocery Multiples*, 2005.

¹⁰We define supermarkets as grocery stores where the space devoted to the retail sale of groceries exceeds 280 sq metres, while convenience stores are grocery outlets of a smaller size than 280 sq metres. This distinction is consistent with previous CC inquiries, such as the inquiry into the proposed acquisition of Safeway in 2003, as well as the relevant legal threshold for extended opening hours in the Sunday Trading Act 1994.

¹¹IGD, *UK Grocery Retailing*, 2006. As well as specialist grocery stores, 'other outlets' include newsagents and off-licences of less than 280 sq metres that do not have the same long opening hours and product range as convenience stores.

supermarkets, 20 per cent from convenience stores and 13 per cent from other outlets in 2000.

TABLE 1 **Grocery retailing in the UK**

	2000		2006	
	No of outlets	Sales (£bn in 2006 prices)	No of outlets	Sales (£bn in 2006 prices)
Supermarkets	6,542	70.8	6,401	89.2
Convenience stores	55,798	21.0	51,526	24.9
— Retail chains	2,715	2.4	2,427	3.1
— Co-operatives	1,236	1.1	2,334	2.6
— Symbol group retailers	6,961	4.4	13,035	8.2
— Non-affiliated independents	35,500	9.7	25,893	7.3
— Forecourts	10,061	3.5	7,837	3.7
Other outlets, including specialist grocery stores	51,822	13.7	44,584	9.4
Total	114,162	105.7	102,511	123.5

Source: CC analysis of data from IGD, *UK Grocery Retailing*, 2001 and 2006, and IGD, *UK Convenience Retailing*, 2006.

Notes:

1. Figures do not sum due to rounding.
2. In relation to convenience stores: retail chains include, for example, Sainsbury's and Tesco; co-operatives include, for example, The Co-operative Group; symbol group retailers include, for example, Spar and Costcutter; forecourts include, for example, Shell and BP.
3. In relation to other outlets, these include off-licences as well as specialist grocery stores such as butchers and bakers.
4. Excludes joint ventures to avoid double counting store numbers.

TABLE 2 **Specialist grocery stores in the UK**

	2000		2005	
	No of outlets	Sales (£bn in 2005 prices)	No of outlets	Sales (£bn in 2005 prices)
Specialist grocery stores	40,351	7.8	37,521	7.9
— Bakers		2.1		2.3
— Butchers		2.4		2.6
— Fishmongers		0.2		0.2
— Greengrocers		1.4		1.3
— Others*		1.6		1.6

Source: Verdict, *Neighbourhood retailing*, 2006.

*Includes delicatessens, cheese shops and chocolatiers, but does not include off-licences.

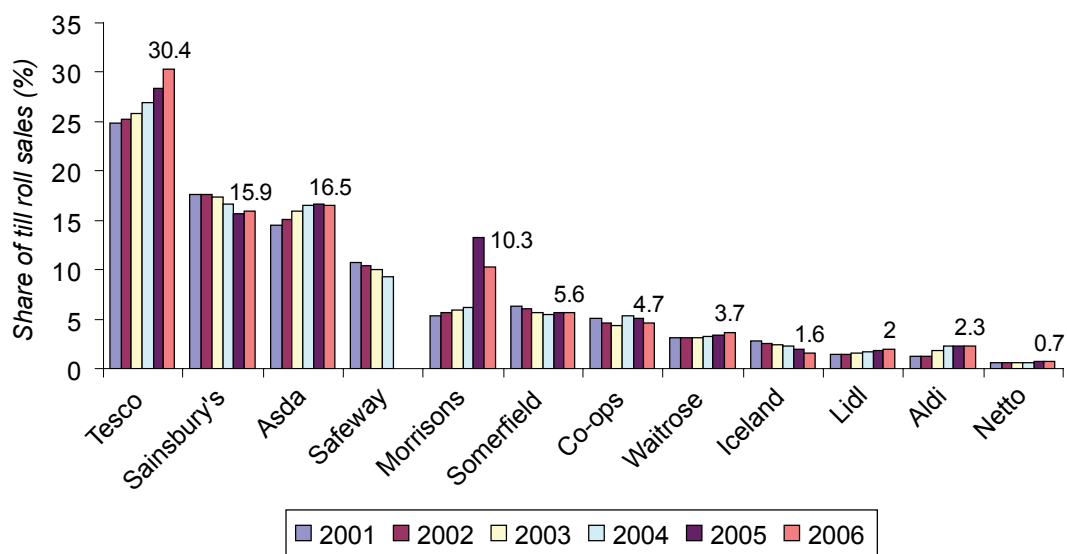
33. Between 2000 and 2006, supermarket sales increased by 26 per cent in real terms and convenience stores sales increased by 19 per cent in real terms. However, sales at specialist grocery stores increased by only 1 per cent in real terms. Over this same period, the number of supermarkets declined by 2 per cent from 6,542 to 6,401, while the number of convenience stores decreased by 8 per cent from 55,798 to 51,526. By 2005, the number of specialist grocery stores had declined by 7 per cent from 40,351 to 37,521.

34. Total store numbers for the major UK supermarket chains, including both supermarkets and convenience stores, are set out in Table 3. The largest increase in store numbers between 2000 and 2006 was achieved by Tesco, which, by adding around 1,200 stores, nearly trebled its store count during this period. A significant number of these new stores resulted from its acquisition of T&S Stores in 2003 (see paragraph 37). Morrisons also added a large number of stores to its network during this period, primarily as a result of its acquisition of Safeway in 2003.
35. In 2006, the four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco) accounted for nearly three-quarters of all grocery sales at supermarkets and convenience stores. In the period since 2000, Asda, Morrisons and Tesco each increased their share of these sales, with the major increase by Morrisons stemming from its acquisition of Safeway. Sainsbury's, however, lost sales share over this period (see Figure 1).
36. The growth in non-grocery retailing has been a significant development in the profile of the major grocery retailers since 2000. Sales of non-grocery products by grocery retailers increased by an estimated 89 per cent between 2000 and 2004.¹² This was the result of substantial space expansions in categories such as health and beauty, clothing, and entertainment.

¹²CC estimate based on Mintel, *Non-foods in Grocery Multiples*, Retail Intelligence, April 2005.

FIGURE 1

National sales shares by grocery retailer, 2001 to 2006



Source: IGD Grocery Retailing 2005 and 2006, quoting TNS total till roll data, for 52 weeks ending February of the relevant year.

Note: National sales shares excludes sales at specialist grocery retailers and other grocery outlets such as butchers, Boots, chemists and M&S.

37. Another significant change to the profile of two of the UK's largest grocery retailers, Tesco and Sainsbury's, in the period since 2000 has been their expansion into the convenience sector. In both cases, this expansion was assisted by the acquisition of significant convenience store chains. In 2004, Tesco acquired T&S Stores plc, owner of the One Stop and Day and Night fascias, through which it gained around 850 convenience stores. Also in 2004, Sainsbury's acquired Jacksons Stores Ltd through which it gained approximately 110 convenience stores.¹³ At the end of 2006, Tesco owned 1,150 convenience stores, while Sainsbury's had a network of 287 convenience stores.¹⁴ Together, this represents approximately 3 per cent of all convenience stores in the UK. We discuss trends in convenience store retailing in further detail in paragraphs 39 to 41.

¹³See OFT, *Proposed acquisition by Tesco plc of T&S Stores plc*, 3 February 2004 and OFT, *Completed acquisition by J Sainsbury plc of Jacksons Stores Ltd*, 26 October 2004.

¹⁴IGD, *The Knowledge Store*, 2006.

TABLE 3 Number of UK stores operated by the UK's largest grocery retailers

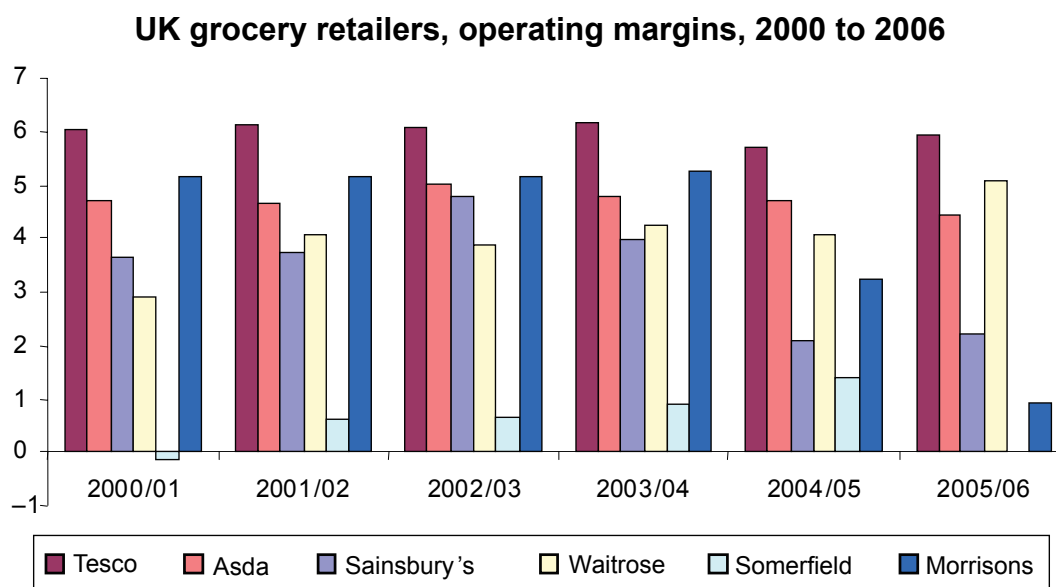
Grocery retailer	2001	2002	2003	2004	2005	2006
Asda	241	249	258	259	275	305
Iceland	764	764	754	748	730	695
M&S	303	312	331	375	397	408
Morrisons	110	113	119	125	498	373
Safeway	525	527	536	536	0	0
Sainsbury's	436	447	498	583	727	752
Somerfield	1,323	1,283	1,269	1,268	1,308	1,424
Tesco	685	729	1,982	1,878	1,780	1,898
Waitrose	136	138	141	145	167	173

Source: IGD, Grocery retailing, September 2006.

Note: Store numbers include both supermarkets and convenience stores.

38. Figure 2 shows movements in operating margins for six of the largest grocery retailers in the UK since 2000. During this period, average operating margins declined from 4.5 to 4.0 per cent. There were, however, significant variations between the grocery retailers during this period. Tesco consistently earned higher operating margins than the other five grocery retailers shown in Figure 2 over this period.

FIGURE 2



Source: IGD, UK Grocery Retailing, 2006.

Note: Somerfield data for 2005/06 is not yet available.

39. As shown in Table 1, convenience stores may be categorized as being owned by a retail chain (eg Tesco or Sainsbury's), a co-operative (eg The Co-operative Group), a

symbol group (eg SPAR), a non-affiliated independent or a forecourt (eg BP, Shell). Between 2000 and 2006, the number of convenience stores affiliated to symbol groups or part of co-operatives increased by around 87 per cent, while the number of non-affiliated independent convenience stores declined by nearly one-quarter. After allowing for the movement of non-affiliated independent convenience stores to symbol groups, and possibly co-operatives, the net loss of non-affiliated independent convenience stores was approximately 2,400 stores or around 7 per cent of the total number of non-affiliated independent convenience stores that were trading in 2000.

40. The number of convenience stores owned by the four largest grocery retailers increased from 54 in 2000 to 1,306 in 2005¹⁵ (out of a total of more than 50,000), but the overall number of convenience stores owned by all grocery retail chains declined by slightly more than 10 per cent.¹⁶ Northern Ireland is distinguished from other parts of the UK by the fact that there are few, if any, non-affiliated independent convenience stores.
41. Symbol group retailers are, by revenue, the largest segment of the convenience store sector. Major symbol groups in the UK are shown in Table 4. These include Spar, Budgens/Londis, Premier and Costcutter. Symbol groups will often be linked to specific wholesalers and may also be part of a buying group (see Table 5 and paragraph 46).

¹⁵OFT, *The grocery market: the OFT's reasons for making a reference to the Competition Commission*, May 2006, p11.

¹⁶This is because Sainsbury's acquisition of Jacksons Stores and Tesco's acquisition of T&S Stores represented a transfer of ownership from one grocery retail chain to another grocery retail chain thus not affecting the overall number of convenience stores owned by grocery retail chains.

TABLE 4 **Symbol group retailers in the UK**

<i>Symbol group</i>	<i>No of stores</i>
Spar UK	2,724
Budgens/Budgens Local/Londis (Musgrave)	2,087
Premier (Booker)	1,900
Lifestyle/Scandia (Landmark)	1,440
Costcutter	1,400
Nisa Today's	1,040
Best In/Best One (Bestway)	920
P&H Retail (including Mace, Mace Express, Supershop and Your Store)	710
Key Store/Shop (Key Lekkerland)	342
VG/Vivo (Northern Ireland)	102
Centra (Musgrave NI)	65
<hr/>	
Tesco	1,150
Sainsbury's	287

Source: IGD, *Symbol Groups—Market Overview*, 2006; IGD, *The Knowledge Store*, 2006.

Note: Tesco and Sainsbury's are not symbol groups but have been included in this table for the purposes of comparison.

42. Grocery retailers are vertically integrated upstream to varying degrees. Most supermarket chains¹⁷ purchase grocery products for resale directly from food and drink manufacturers and processors, and in a few cases supermarket chains own their own food manufacturing or primary production facilities.¹⁸

43. The degree to which convenience stores are integrated with a wholesale purchasing function differs across the sector. Convenience stores owned by a supermarket chain or part of a co-operative will be serviced by a common purchasing system, and convenience stores that are members of a symbol group will share the same wholesaler (although this relationship may not always be exclusive). Non-affiliated independent convenience stores, however, will generally purchase supplies through a cash-and-carry wholesaler.

Grocery wholesalers

44. There are two major segments in the grocery wholesaling trade: cash-and-carry wholesalers, which primarily supply non-affiliated independent convenience stores,

¹⁷A supermarket chain is a grocery retailer that predominantly operates supermarkets, eg Asda, Morrisons, Sainsbury's, Tesco.

¹⁸Morrisons, for example, owns a number of food production facilities.

and delivered wholesalers, which primarily supply convenience stores affiliated to a symbol group. Of the £16.8 billion in revenues for grocery wholesaling in 2005, those wholesalers primarily engaged in cash-and-carry wholesaling accounted for approximately 55 per cent of wholesaling revenues, while those wholesalers primarily engaged in delivered wholesaling accounted for the remaining 45 per cent of wholesaling revenues.

TABLE 5 Major grocery wholesalers in the UK

<i>Company</i>	<i>Principle mode of operation</i>	<i>Turnover £m</i>	<i>Share of revenues %</i>	<i>Symbol group</i>	<i>Buying group affiliation</i>
Palmer & Harvey McLane Ltd	Delivered	3,533	20.8	Mace, Mace Express, Super Shop Premier	
Booker Ltd	Cash and carry	3,228	19.0		
Bestway Cash & Carry Ltd (incl Batleys)	Cash and carry	1,600	9.4	Best One	
Makro Self Service Wholesalers Ltd	Cash and carry	1,100	6.5		Today's
Costco Wholesale UK Ltd	Cash and carry	953	5.6		
AF Blakemore and Son Ltd	Delivered	622	3.7	Spar	Spar
Londis (Holdings) Ltd	Delivered	527	3.1	Londis	Today's
James Hall and Company (Holdings) Ltd	Delivered	314	1.8	Spar	Spar
Dhamecha Foods Ltd	Cash and carry	271	1.6		Today's
Capper & Co Ltd	Delivered	253	1.5	Spar	Spar
CJ Lang & Son Ltd	Delivered	237	1.4	Spar	Spar
Henderson Wholesale Ltd	Delivered	233	1.4	Spar	Spar
AG Parfett & Sons Ltd	Cash and carry	219	1.3		Landmark
Woodward Foodservice Ltd	Delivered	148	0.9		
JW Filshill Ltd	Delivered	147	0.9		Key Leckerland
Appleby Westward Group plc Total	Delivered	<u>142</u>	<u>0.8</u>	Spar	Spar
		13,502	79.4		

Source: IGD and Companies House.

45. There are more than 400 grocery wholesalers in the UK. The 16 largest wholesalers (see Table 5) account for nearly 80 per cent of grocery wholesaling revenues, while the two largest wholesalers—Palmer & Harvey McLane (delivered) and Booker (cash and carry)—account for nearly 40 per cent of the total market and individually more than 30 per cent of their respective sectors.

46. Most grocery wholesalers are affiliated to a buying group (see Table 5). These buying groups are affiliations of several wholesalers that have been established so as to obtain more favourable terms from suppliers than each wholesaler could achieve individually.

47. In recent years, wholesalers have been developing their own symbol groups. For example, since 2000 Booker, a cash-and-carry wholesaler, has recruited almost 2,000 independent store owners to its Premier symbol group. The development of symbol groups by cash-and-carry wholesalers has led to some blurring between the cash-and-carry and delivered segments as cash-and-carry operators have started providing delivery services to their own symbol groups and others.

Grocery suppliers

48. Grocery suppliers include manufacturers of food, drink and other grocery products, including manufacturers of both branded and own-label products, primary producers, intermediate processors of primary products (eg abattoirs), other primary sector intermediaries (eg farmers' co-operatives), and grocery wholesalers.
49. The food and drink manufacturing sector includes companies, such as Cadbury, Coca-Cola Enterprises, Heinz, Nestlé and Unilever, that manufacture well-known branded goods, as well as other large firms, such as Northern Foods, Princes and RHM, that supply both branded and own-label goods to the grocery retailers. Together, the sector includes more than 6,000 enterprises.¹⁹
50. There are a number of examples of supply chain consolidation in this period, including mergers in the milk, sugar distribution, salt, sauces and carbonated soft drinks sectors that have each been referred to the CC.²⁰ These examples are consistent with Defra observations that concentration is high in many food and drink manufacturing industries and that there has been a net exit from the sector in the

¹⁹Food and Drink Federation, Industry Statistics at www.fdf.org.uk.

²⁰See *Arla Foods amba and Express Dairies plc: a report on the proposed merger*, October 2003; *James Budgett Sugars Ltd and Napier Brown Foods PLC: a report on the acquisition by Napier Brown Foods PLC of James Budgett Sugars Ltd*, March 2005; *British Salt Limited and New Cheshire Salt Works Limited: a report on the acquisition by British Salt Limited of New Cheshire Salt Works Limited*, November 2005; *HJ Heinz and HP Foods: a report on the completed acquisition of the HP Foods companies by HJ Heinz Company and HJ Heinz Company Ltd*, 24 March 2006; and *Cott Beverages Limited and Macaw (Holdings) Limited: a report on the acquisition by Cott Beverages Limited of Macaw (Holdings) Limited*, 28 April 2006 (all published by TSO and available on our website).

past decade.²¹ Defra has also conducted an analysis of market intelligence reports from Mintel, a market research organization, that shows that in more than half of food manufacturing categories, the share of sales for the largest three companies exceeds 50 per cent.²²

51. Further upstream, there were approximately 307,000 agricultural holdings in the UK in 2005 with the largest number of holdings in the cattle and sheep sectors followed by cereals and dairy farming. According to Defra statistics, the number of agricultural holdings in the UK has increased by 5 to 10 per cent since 2000, predominantly in small 'hobby' farms, while the total land area used for agricultural purposes in the UK has remained stable at around 18.5 million hectares. Defra estimates that, since 2000, gross agricultural output has declined by nearly 1 per cent.²³
52. Since 2000 many primary producers have been affected by the reform of the Common Agricultural Policy (CAP), which has decoupled subsidy payments from production levels, as well as the challenges presented by incidents such as foot and mouth disease in addition to those of supplying, albeit in many cases indirectly, the UK's grocery retailers. Imports of food and drink increased by 24 per cent, in real terms, from £17.7 billion in 2000 to £21.9 billion in 2004. This compares to an increase in exports of 6 per cent over the same period.²⁴
53. The length of the supply chain and the extent to which various suppliers are dependent on sales through grocery retailers varies across the supply base. The supply chain for carbonated soft drinks, for example, is relatively short with

²¹Defra, *UK Food and Drink Manufacturing: an economic analysis*, May 2006.

²²Defra analysed data in more than 70 Mintel market research reports from 2003 onwards to calculate these ratios. The ratios were calculated across market sectors defined by Mintel. In some cases the shares were estimated by volume and in some cases by value. In 70 per cent of the industries analysed, the share of the three largest companies exceeded 50 per cent.

²³Defra, *Agriculture in the UK*, 2005, Tables 2.5 and 3.5.

²⁴This increase in food imports was seen across each of the unprocessed (20 per cent), lightly processed (21 per cent) and highly processed (30 per cent) categories. More than three-quarters of the growth in food and drink imports was from other countries within the EU.

manufacturers supplying directly to supermarket chains and grocery wholesalers. Farmers, however, will generally sell their produce to marketing agents or processors prior to it being supplied to supermarket chains or grocery wholesalers. It is less common for primary producers to sell directly to grocery retailers.

Consumers

54. The CC's previous investigation into supermarkets in the UK in 1999/2000 took a shopping-mission-centred approach to defining the relevant markets. This was based on the concept of a primary weekly shop and additional secondary or 'top-up' shopping (see paragraphs 62 to 64 below). We have, however, been told of changes in consumer behaviour in recent years. For example, grocery retailers have also told us of a trend towards more frequent shopping trips due to the increased importance of fresh and chilled product categories (although the evidence in support of this claim is not clear). We have also been told of increased switching between grocery retailers by consumers. TNS Worldpanel data provided by Tesco suggests that the value of consumer switching has increased from less than £6 billion (6 per cent of total grocery sales) in 2002 to over £10 billion (8 per cent of total grocery sales) in 2005.
55. Internet-based shopping has also expanded significantly in recent years although it still constitutes only 1 to 2 per cent of total UK grocery sales.²⁵ Developments to the Internet since 2000 mean that it is also now far easier for consumers to compare prices between grocery retailers.

CC supermarket investigation in 1999/2000 and subsequent developments

56. The current investigation into the supply of groceries in the UK follows the CC's inquiry in 1999/2000 into the supply of groceries from multiple stores ('the 2000

²⁵Verdict, *e-retail*, 2006 estimated total internet grocery shopping in 2005 to be worth £1,864 million.

investigation')²⁶ as well as the CC's inquiry into the proposed acquisition of Safeway in 2003 and its inquiry into Somerfield's acquisition of a number of stores divested by Morrisons following its acquisition of Safeway.²⁷ An overview of each of these inquiries as well as developments in relation to the Supermarket Code of Practice that was implemented following the 2000 investigation is set out in paragraphs 57 to 73 below.

Overview of the CC's supermarket investigation in 1999/2000

57. At the time of the 2000 investigation, the CC was required to consider markets under a different framework to the current test for a CC market investigation, which is set out in paragraphs 5 and 6 above. The main elements of the former framework for CC investigations were as follows:

- First, the CC was required to identify whether there was a monopoly situation (which included identification of a complex monopoly situation in which two or more persons conduct their respective affairs, voluntarily or not, in a way to prevent, restrict or distort competition).
- Second, the CC was required to identify persons in whose favour the monopoly situation exists and consider whether any steps were being taken by such persons for the purpose of exploiting that position or whether any actions or omissions were attributed to the monopoly situation.
- Finally, the CC was required to consider whether any of the facts found by it operated or were expected to operate against the public interest. If it made an adverse public interest finding, the CC was required to consider whether any remedial action should be taken, and if so to make recommendations to the

²⁶For the 2000 investigation, the relevant stores for the purposes of the investigation were supermarkets with 600 sq metres or more of grocery sales area, where the space devoted to the retail sale of food and non-alcoholic drinks exceeds 300 sq metres and which are controlled by a person who controls ten or more such stores.

²⁷CC, *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc: a report on the mergers in contemplation*, TSO, September 2003; CC, *Somerfield plc and Wm Morrison Supermarkets plc: a report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc*, TSO, September 2005.

58. Two complex monopoly findings were made in the 2000 investigation, the first relating to the pricing practices of a number of grocery retailers, and the second relating to the actions of five grocery retailers towards their suppliers.
59. Concerning pricing practices, the CC found that both persistent below-cost selling of some frequently-purchased products and varying prices in different locations in response to local competitive conditions (such variation not being related to costs) contributed to a situation in which the majority of grocery products were not fully exposed to competitive pressure. The CC considered that these practices distorted competition in the supply of groceries and operated against the public interest. The CC did not, however, recommend remedial action given its overall finding that the market was generally competitive. The CC also found that a number of multiple grocery retailers adopted pricing structures and regimes that, by focusing on a relatively small proportion of their product line, restricted active competition on the majority of the product lines. Though the CC found that there was a distortion of competition in the supply of groceries, it did not make an adverse public interest finding and hence made no recommendation for remedial action.
60. In relation to suppliers, the CC found that five grocery retailers each having at least an 8 per cent share of grocery purchases had sufficient buyer power that 30 separate practices identified by the CC had the effect of adversely affecting the competitiveness of some of their suppliers and distorting competition among grocery suppliers—and in some cases among grocery retailers—and that 27 of these practices operated against the public interest. The CC recommended that a Code of Practice be adopted to address the concerns it identified. Subsequently, Asda, Safeway, Sainsbury's and Tesco each provided undertakings that they would comply with the proposed Code of

Practice.²⁸ Under these undertakings, the OFT is responsible for monitoring compliance with the Code of Practice. We review developments under the Code of Practice in paragraphs 70 to 73 below.

61. The CC stated that the industry was broadly competitive and that, overall, excess prices were not being charged nor excessive profits earned. It had, however, concerns that in some areas of the UK some consumers had a limited choice of supermarket fascia for one-stop grocery retailing (see paragraph 62 below for definition of one-stop grocery retailing) and that any further local concentration could weaken competition in some areas. The CC noted that the planning system was not designed to safeguard competition and consumer choice in multiple grocery retailing and believed that there was no way of addressing this lack of consumer choice through changes to the planning regime. It made a recommendation (though not as a remedy designed to address its public interest findings) that, in certain clearly defined circumstances, OFT approval should be required for particular parties to be allowed to acquire or develop large new stores or significantly extend the grocery retailing area of an existing store. This recommendation was not taken forward, and the OFT recently explained, in evidence to the Barker Review of Planning, that it did not prove practical for it to examine all new site developments.²⁹
62. A key part of the framework for the CC's consideration of competition between supermarkets in the 2000 investigation was its definition of the relevant markets for the supply of groceries. In considering the relevant markets, the CC distinguished between shopping of a type designed to meet consumers' weekly grocery needs in a single trip and under one roof (one-stop shopping) and other types of grocery shopping (secondary or top-up shopping).

²⁸Somerfield, the fifth grocery retailer identified by the CC, was subsequently found to have a market share of less than 8 per cent, and as a result, was excluded from providing undertakings to the OFT.

²⁹Barker K., *Barker Review of Land Use Planning—Final Report*, December 2006, p15.

63. The CC considered that the minimum store size required for a one-stop shop was 1,400 sq metres. That is, only those grocery outlets of this size or greater competed for consumers' one-stop shopping.³⁰ However, in relation to top-up shopping, the CC considered that all grocery outlets, regardless of size, competed in this market.³¹
64. In relation to the geographic market, the CC found that for one-stop shopping carried out in stores of 1,400 sq metres or greater, shopping patterns were essentially local with most consumers travelling no more than 10 minutes to a supermarket in urban areas and no more than 15 minutes in non-urban areas. The CC noted that though the geographic extent of the market broadly corresponded to local catchment areas, it may be wider in some areas, depending on the degree of overlap of such catchments.

The Safeway and Somerfield/Morrisons merger inquiries

65. Since the 2000 investigation, the CC has undertaken two merger inquiries in the grocery retailing sector. These were the proposed acquisition of Safeway by each of Asda, Morrisons, Sainsbury's and Tesco in 2003 (the Safeway inquiry), and the completed acquisition by Somerfield of 115 grocery stores from Morrisons in 2005 (the Somerfield inquiry).
66. In relation to the Safeway inquiry, the CC identified adverse effects resulting from the potential acquisition of Safeway by any of Asda, Sainsbury's or Tesco. It found that a reduced number of national grocery retailers, and reduced competition and choice in local markets, would lead to prices in the one-stop grocery market being higher than would otherwise be the case. It also found that there would be less competition for

³⁰The CC excluded M&S stores from the definition of one-stop shops, notwithstanding that some of its food halls met the 1,400 sq metre criterion, because M&S only offered own-label goods, lacked full food product range, generally did not offer flat car parking and had a more limited range of non-food grocery products.

³¹We note that in the broader public discussion this market definition finding, often referred to as the 'two markets' definition, has often been interpreted as meaning that only smaller grocery outlets compete for top-up shopping. This is not correct.

new sites and a reduced threat of entry in those areas where Safeway was not currently represented, further intensifying the conditions favourable to coordinated effects. It also found that some suppliers' positions would be weakened by the further imbalance in the respective bargaining position of Asda, Sainsbury's and Tesco.

67. As to the potential acquisition of Safeway by Morrisons, the CC found that this might not be expected to exacerbate the conditions in which coordinated effects were likely to occur. However, an acquisition by Morrisons might be expected to have adverse effects in particular local areas through a reduction in the number of one-stop grocery shops and store fascias, resulting in higher prices for groceries in those areas.
68. The CC recommended that Morrisons be allowed to acquire Safeway subject to the divestment of a number of stores, and that Asda, Sainsbury's and Tesco be prohibited from acquiring the whole or any part of Safeway (other than those stores divested to remedy the adverse effect of a merger between Morrisons and Safeway). The Secretary of State accepted the CC's recommendations. Morrisons subsequently gave undertakings to the OFT that it would divest around 50 stores, and in March 2004 completed its acquisition of Safeway.
69. The Somerfield inquiry arose from Somerfield's acquisition of 115 grocery stores that Morrisons divested subsequent to its acquisition of Safeway. The CC found that the acquisition might be expected to result in a substantial lessening of competition (SLC) in each of the local markets served by 12 of the stores acquired by Somerfield, and required Somerfield to divest a store to a suitable purchaser in each of these localities. Somerfield applied to the Competition Appeal Tribunal for an order quashing those parts of the report that dealt with divestment but its application was dismissed. Undertakings to divest the 12 stores were accepted by the CC in March 2006.

Developments under the Supermarket Code of Practice

70. The Supermarket Code of Practice, as set out in paragraph 60 above, was put in place in response to the findings made in the CC's 2000 investigation and came into force in March 2002. The Code is different from that recommended by the CC in that it permits grocery retailers to seek from suppliers certain payments, contributions and so on for promotions and other matters provided their requests are reasonable. The OFT, in reporting on the operation of the Code in 2005, stated that it considered that the concept of 'reasonableness' avoided undue regulatory prescriptiveness that could introduce rigidities in the relationships between grocery retailers and their suppliers. This flexibility may also have resulted in the Code imposing a limited constraint on the grocery retailers.
71. Soon after its introduction, concerns were raised regarding the effectiveness of the Code and in December 2002 the Government committed the OFT to preparing an annual report on how the Code was working. These concerns were again reflected in the CC's report on the proposed acquisition of Safeway in 2003 and the OFT's first review of the Code published in February 2004. The OFT subsequently commissioned an audit by PKF of the four grocery retailers' compliance with the Code the results of which were published in March 2005. PKF found that, by and large, the four grocery retailers had complied with the Code and that the breaches that had been found did not suggest that non-compliance was widespread.
72. Certainly, the number of official complaints under the Code has been small (we are only aware of one). However, this might be expected given the flexibility of the Code's provisions. Many suppliers and trade associations have spoken to us about a 'climate of fear' associated with making complaints about the four large grocery retailers. This was also a factor in the CC's 2000 investigation as well as subsequent interactions between suppliers and the OFT concerning the operation of the Code.

This has also been a factor in the current investigation and we return to this issue, including the steps we are taking to encourage the provision of evidence to our investigation, in paragraph 102 below.

73. More generally, while the purpose of our investigation is not specifically to review the effectiveness of the Code, we are, of course, considering the impact of the Code in our assessment of the relationship between grocery retailers and their suppliers. We discuss this further in paragraphs 125 and 126.

Competition and other issues of concern

74. In our statement of issues published on 15 June 2006 we set out what we consider to be the most important issues relating to competition in the supply of groceries by retailers in the UK. These are: first, the behaviour of grocery retailers towards their suppliers; second, the conduct of grocery retailers and consumers as well as the structure of any local market for groceries; and finally, planning and land use issues. This document discusses each of these issues in paragraphs 99 to 169.
75. Other issues that have been brought to our attention, in addition to those set out above, include the impact of grocery retailing on the nation's health, including the social impact of low-priced alcohol sales, the importance of high streets and rural shops to social cohesion, the future of UK farming and the importance of self-sufficiency in food, working conditions at grocery suppliers in the developing world, and the environmental impact of the grocery supply chain.
76. The Food Poverty Project submitted that a reduction in choice in relation to grocery retailing was limiting customers', particularly disadvantaged customers', choice of healthy food options. It considered that contributing factors include the predominance of processed food in grocery outlets, particularly convenience stores owned by the

supermarket chains and, citing research by the National Consumer Council, special offers focused on unhealthy products.³²

77. The Rural Shops Alliance submitted that the expansion of grocery superstores and the potential loss of village stores will be devastating in social terms to the communities they serve. Similarly, the National Federation of Women's Institutes (NFWI) submitted that the expansion of supermarket chains was resulting in the loss of local independent shops and told us of its concern about the impact that this was having on communities in the UK.
78. The NFWI also told us that supermarket purchasing practices were forcing UK farmers out of business and that this was undermining the maintenance of thriving rural and urban communities as well as the nation's health and security. Compassion in World Farming submitted that low farmgate prices were making it extremely difficult for farmers to produce to good animal welfare standards.
79. Banana Link submitted that many plantation workers employed by companies supplying British supermarkets were failing to earn either a living or legal minimum wage. Banana Link considered that there was evidence to suggest that this was a direct result of the prices paid to suppliers by British supermarket chains. Similarly, Traidcraft told us that the large grocery retailers, due to their size, were able to pass disproportionate risks on to their suppliers, who then passed risks on to workers and smallholder farmers, particularly in developing countries. ActionAid and Women Working Worldwide told us that these pressures were reflected in lower pay, excessively long working hours, forced overtime, increased use of temporary contracts and dangerous working conditions.

³²See, for example, National Consumer Council, *Short-changed on health?*, 2006.

80. A range of environmental concerns have also been brought to our attention. Farmers' Link cited wasted fresh produce resulting from grocery retailers' visual requirements leading to increased pesticide use, which in itself may have adverse environmental impacts. It also noted the costs associated with food packaging and the environmental impact of food transport, including the import of food products from distant locations.
81. In a number of cases, these concerns interact with competition issues and provide background and context for our investigation. For example, while the sale of CDs does not fall within our definition of groceries for the purposes of this inquiry, the concerns raised by the Association of Independent Music regarding below-cost selling of CDs by grocery retailers are similar to the broader issues of below-cost selling that we address in this paper and the working paper on this subject. Similarly, the concerns raised by Oxfam regarding potential breaches of the Supermarket Code of Practice by grocery retailers in relation to their foreign suppliers are relevant in the overall context of our assessment of grocery retailers' buyer power and supply chain practices.
82. We have given careful consideration to all the issues that have been raised with us to assess the extent to which they impinge on competition, and we will continue to do so. However, in some cases, the evidence submitted to us bears on issues beyond competition. We appreciate the importance placed on these issues by those parties that have made submissions to us. We need to be sure though that we are acting within our statutory powers, and where evidence submitted to us bears on issues beyond competition, these are not things that we have the power to investigate or resolve.

83. What is clear to us already, however, is that the apparent consumer benefits in terms of low prices, convenience and product variety that result from competition between grocery retailers may involve other costs in terms of environmental effects (eg planning and development, increased production of waste, increase in road traffic), changes affecting the UK agricultural industry (through international sourcing), and more remotely, affecting the balance of dietary health (greater availability of cheaper but processed foods).
84. The fact that these potential costs may be being incurred reflects, in part, policy choices made by national or local government (eg the preference for retail development in town centres) and, in part, reflects preferences shown by consumers (eg driving to supermarkets for convenience). To that extent, the current state of the UK grocery market is a reflection of the combined effect of a number of factors, to which grocery retailers, in particular the large supermarket chains, have simply made a rational response and which consumers appear largely to have supported. However, once the costs of these factors become clearer, it may be that consumers will not continue to support the expansion of grocery retailers to the same extent, and may exercise their choice of product or outlet in a way that better reflects a balance between access to cheap, convenient groceries in large quantities and other factors that they value. In a market where competition is effective, if consumers did exercise their choice in this way, grocery retailers would have to follow and alter their offering, or lose customers, market share and profit.

Market definition

85. The following paragraphs, together with the accompanying working paper on market definition, set out our approach to defining the relevant market(s) for the purposes of this investigation and our initial thinking concerning the relevant product and geographic market(s). Market definition is not an end in itself but rather a framework

within which to analyse the effects of market features and to identify competitive constraints. We recognize that the approach used in this investigation to define the market for the retail supply of groceries may also guide future merger activity among grocery retailers.

86. We are still in the early stages of analysing much of the quantitative data that has been submitted to the inquiry regarding stores and shopping patterns. As a result, our thinking is preliminary and we aim to publish additional analysis in the period leading up to the publication of our provisional findings.
87. In defining the relevant market, we are considering both demand- and supply-side substitution. Demand-side substitution occurs when consumers switch either all or part of their grocery expenditure to another store. This might be in response to a change in price, but may also be in response to a change in one or more of the other non-price aspects on which stores compete. Supply-side substitution would involve entry into a particular location with the opening of new outlets only if this can occur in a short period of time with little or no investment, or it may involve expansion of an existing store or brand repositioning.³³ In defining the relevant markets for grocery retailing, we consider that demand-side substitution is likely to be more relevant than supply-side substitution.
88. We discuss the relevant market(s) for the supply of groceries to consumers (ie the market served by grocery retailers) in paragraphs 89 to 98. Our proposed approach to the definition of upstream markets for the wholesale supply of groceries to grocery retailers should be noted. We are not seeking at this stage to define comprehensively each upstream market as we do not consider this to be a practical way forward, given

³³In assessing the extent of this substitutability we will be applying the framework of the SSNIP (small but significant non-transitory increase in price) test consistent with our guidelines (see CC, *Market Investigation References—Competition Commission Guidelines*, CC3, June 2003).

the large number of separate markets that are likely to be involved. Our competition analysis, however, will assess whether there are any features relevant to the upstream markets for the supply of groceries to grocery retailers. We will develop our approach in this area, as required, as we proceed with our analysis.

Product market

89. There are many differentiating factors between grocery retailers from a consumer's viewpoint. These include price, range of products, quality of products, cleanliness, parking facilities and so on. The sum of these aspects is the 'retail offer' which is essentially the 'product' sold by retailers to consumers.³⁴
90. The importance of these different factors may vary according to consumers' needs in relation to a particular shopping mission. Consumer research indicates that price is the most important factor in consumers' choice of their main grocery store, but that shoppers in smaller stores place far more importance on geographical convenience compared with other factors (see working paper on market definition).
91. As set out in paragraph 62, previous CC investigations into the supermarket sector have taken an approach to market definition based on consumers' shopping mission (ie one-stop or secondary). We have been informed that a number of trends have emerged in recent years, including increased frequency of shopping due to the increased importance of fresh and chilled product categories, which have blurred the distinction between shopping missions. These developments may mean that a shopping-mission-centred approach to defining product markets is no longer appropriate.

³⁴We generally refer to non-price factors as quality, range and service. The total 'product' may then be referred to in terms of price, quality, range and service, or 'PQRS'.

92. An alternative approach to defining the product market may be to look directly at the factors differentiating grocery retailers. Store size and store fascia are, for example, two observable criteria that may capture many of the aspects of a store's retail offer. Close competitors are likely to have similar 'retail offers' in that stores of similar sizes and fascia with similar offers are more likely to compete with each other. We discuss the evidence that has been submitted in relation to these two criteria in the working paper on market definition.
93. Our preliminary thinking is that larger grocery stores are an effective substitute for smaller grocery stores, and as a result, constrain the 'retail offer' of these stores. However, we do not currently view smaller grocery outlets as providing a similarly effective substitute for larger grocery stores. Further it is not clear that consumers view the retail offer of different grocery retailers of the same size as equally substitutable. A premium food-focused grocery retailer, such as M&S, may be in a separate product market to LADs, such as Aldi.
94. In the period leading up to the publication of our provisional findings, we will, as noted in paragraph 86, be undertaking a quantitative analysis of consumer shopping patterns to assess the extent of any competitive constraints between different stores and how this varies in terms of factors such as store size, fascia and other price and non-price variables.

Geographic market

95. The weight of evidence to date supports a finding that the relevant geographic market for the supply of groceries is local, rather than national. Evidence submitted to us on consumer preferences, retailers' own assessments, local price and range flexing and other localized marketing activities and, to a lesser extent, the impact of

new stores on incumbent stores within the local region all support a local market approach. The majority of parties also support a local, rather than national, approach.

96. A range of estimates have been submitted to us regarding the appropriate drive-time or distance for estimating the catchment area around individual stores. These estimates vary according to store size and urban or rural location, but range from 10 to 20 minutes for larger stores. For smaller stores, evidence has been put to us of the relevant catchment area ranging from 0.5 to 2.0 miles.
97. Arguments have, however, been put to us in favour of a national geographic market. These include national pricing and marketing activities and chains of substitution between retail catchment areas whereby two areas that would not otherwise be in the same geographic market are constrained by their common relationship with one or more areas lying between them.³⁵ Our current view is that chains of substitution may at most lead to local markets of varying sizes rather than a single national market. Internet shopping has the potential to impact on the appropriate definition of the geographic market, but at the moment only constitutes a relatively small share of total grocery expenditure. It may, however, expand the size of local markets by increasing local catchment areas for individual stores. Further, while the major supermarkets may set uniform list prices throughout all their stores in the UK, we consider it plausible that these national prices nonetheless reflect some aggregation of competitive conditions at the local level.
98. In light of the evidence and our analysis to date, and while remaining open on the issue of the appropriate definition of the relevant geographic market, we have adopted a working assumption of local markets for the purpose of progressing our

³⁵See CC, *Market Investigation References—Competition Commission Guidelines*, CC3, June 2003, paragraphs 2.29 to 2.31.

analysis. Our quantitative analysis in the next stage of our investigation will facilitate our assessment of the most appropriate market boundaries.

Competition in groceries

99. The remainder of this document discusses the three issues identified in our issues statement published in June 2006, and previously set out in paragraph 74, as the most relevant to our investigation, namely:

- (a) the behaviour of grocery retailers towards their suppliers (supply chain issues—see paragraphs 100 to 126);
- (b) the structure of any local market for groceries and the conduct of grocery retailers and consumers (market structure and conduct—see paragraphs 127 to 145); and
- (c) the operation of the planning regime and the acquisition, disposal, development or use of land (planning and land use—see paragraphs 146 to 169).

Supply chain issues

100. In response to the concerns that have been raised with us, we are investigating a number of different ways in which grocery retailers' relationships with their suppliers might have an adverse effect on consumers. In particular, we are considering whether the behaviour of grocery retailers towards their suppliers:

- (a) threatens the economic viability of suppliers such that it impacts on the competitiveness and diversity of the supply chain;
- (b) threatens the economic viability of wholesalers such that convenience stores are left without a functioning supply chain;
- (c) causes suppliers to charge higher prices, or offer less favourable terms, than would be justified on grounds of cost, to smaller grocer retailers or wholesalers compared with larger grocery retailers (the so-called 'waterbed' effect);
- (d) causes suppliers to reduce levels of investment and innovation or otherwise compete less vigorously on non-price factors; or

(e) causes suppliers to supply a lesser volume of goods (demand-withholding).

101. We discuss each of these issues below. We also set out below our initial thinking concerning various practices of grocery retailers with respect to their suppliers that have been brought to our attention.
102. Many suppliers and trade associations have spoken to us about a 'climate of fear' associated with suppliers making complaints regarding the conduct of grocery retailers. This has resulted in reluctance on the part of many suppliers to provide the inquiry with details of specific instances to illustrate the general concerns that have been raised with us. A number of trade associations have recently provided the inquiry with further information in response to a request from the CC and we will assess this material in the coming weeks. However, we would encourage other suppliers with information relevant to the inquiry and that have concerns to discuss them with us. We are confident that we will be able to meet any concerns suppliers may have in relation to confidentiality issues.

Supplier viability

103. A number of parties have submitted that the buyer power of grocery retailers is adversely affecting the economic viability of suppliers, particularly primary producers, and this will have adverse consequences for consumers in terms of reduced availability of local produce, greater reliance on food imports and reduced security of supply if foreign supply channels are not reliable in the long term. It may also have adverse environmental consequences in terms of increased 'food miles'.
104. A normal part of the competitive process is the entry and exit of firms. As competition creates incentives for improved processes and increased efficiency, or new opportunities as consumers' tastes change, more efficient firms that are better able to

respond to consumers' tastes will grow, while less efficient firms will exit or be absorbed by others. Our analysis therefore is not concerned with less efficient suppliers being unable to continue in operation as a normal function of competitive processes, but is focused on the more limited circumstances under which grocery retailers' buyer power could lead to the exit of suppliers which would have an adverse impact on consumers as a whole in terms of a loss of choice or variety.

105. In considering this issue, we have conducted an assessment of the profitability of those suppliers located immediately upstream from grocery retailers (ie food and drink manufacturers and processors rather than primary producers) as well as looking in more detail at two parts of the grocery supply chain, milk and pig meat, where concerns have been raised with us. The results of this analysis are set out below while further detail is contained in our working paper on supply chain profitability.
106. Our preliminary analysis does not indicate a systemic problem with the economic viability of food and drink manufacturers and processors. We have not identified an ongoing decline in margins or return on capital for this group of firms. In our own survey of suppliers, less than 4 per cent of suppliers indicated that it was either fairly unlikely or very unlikely that they would be in business in five years' time. Particular parts of the grocery supply chain, however, may be under greater pressure than suppliers as a whole.
107. In relation to milk, prices for dairy farmers have increased slightly since 1999 combining with increased productivity to increase average incomes for dairy farmers. During this period, however, the number of dairy farmers has declined significantly, indicating that many individual farmers have experienced difficulties. Moreover, while average incomes for dairy farmers have increased, it is not clear that this increase in

average income is consistent with an increased return on capital given the increase in the average size of dairy farms over this period. Dairy processors have, since 1999, experienced a slight decline in prices and a declining return on capital employed for much for this period. The benefit of increases in the retail price of milk since 1999 have generally been retained by grocery retailers, increasing their share of milk revenues compared with dairy farmers and processors, and we are concerned to understand why this has been the case.

108. In relation to pig meat, there has been considerable fluctuation in prices and incomes for pig farmers during the period since 1996, reflecting exchange rate fluctuations, changes in input prices and factors such as foot and mouth disease. Improved pig meat prices since 1999 have, on the whole, resulted in improved incomes for pig farmers. Pig farmers also appear to have earned an increasing share of the retail price for pig meat during this period, although, as with dairy farmers, the number of pig farmers has declined significantly, indicating that many individual farmers have experienced difficulties.
109. Pig meat processors have experienced fluctuating margins and returns over the period since 1996 with some improvement in operating margins since 1999. On the basis of the evidence that we have reviewed, movements in the proportion of the retail price shared by processors and grocery retailers are not clear although it does not appear that grocery retailers have increased their share of the retail price for pig meat since 1999.
110. Going forward, we will continue looking at supplier profitability both overall and in individual sectors, particularly in primary producing sectors where concerns are raised with us. Further evidence or comments in relation to the analysis that we have already undertaken would be welcome. We also welcome submissions regarding

other specific primary production sectors where the impact of grocery retailers' buyer power may be analysed further.

Wholesaler viability

111. It has been put to us that the economic viability of the grocery wholesaling sector is being brought into question as a result of the superior buying power of the large supermarket chains combined with a reduction in the number of convenience stores supplied by grocery wholesalers. We were told that a decline in the number of convenience stores supplied by wholesalers would increase the average costs of supplying remaining stores, forcing wholesalers to raise their prices such that further convenience stores would be unable to operate profitably. Accordingly, a 'tipping point' might be reached where the wholesale sector breaks down, leaving remaining convenience stores supplied by wholesalers without a viable supply chain. This may adversely impact on consumers through removing the choice of shopping at these stores or, to the extent that convenience stores provide a competitive constraint on other grocery retailers, allowing these other retailers to increase prices to consumers.
112. Our analysis of the recent financial performance of the wholesaling sector (see working paper on grocery wholesaling) does not indicate that a 'tipping point' of the type described above is imminent. Over the past ten years sector turnover has increased modestly, while profitability has largely been stable.³⁶
113. While industry revenues are generally expected to grow,³⁷ we examined the vulnerability of wholesalers to reductions in trading volumes. We consider that the size of the reduction in turnover that would be required to render an individual

³⁶Our analysis does, however, indicate significant growth for delivered wholesalers compared with relatively stable revenues for cash-and-carry wholesalers. This divergence is consistent with our observation of independent convenience stores, the primary users of cash-and-carry wholesalers, joining symbol groups, which primarily use delivered wholesalers (see paragraphs 44 to 47).

³⁷IGD, *UK Grocery Wholesaling: a strategic guide*, 2006.

wholesaler unviable means that it is unlikely that the wholesale sector would become unviable in the foreseeable future even with significant expansion by supermarket chains in the convenience sector.

114. We recognize, however, that there may be localized consolidation of wholesaling that might result in either convenience store costs increasing as the nearest wholesaler becomes more remote, or an individual wholesaler being in a position to exercise market power over convenience stores in a particular locality. In relation to market power, it seems that a wholesaler is unlikely to increase its prices such that its convenience store customers are competitively disadvantaged compared with other grocery retailers and are at risk of going out of business. We would, however, invite parties to provide further evidence to us regarding the local impacts of any reduction in the number of wholesalers.

Waterbed effect

115. A number of parties have submitted that a so-called 'waterbed' effect exists whereby a grocery supplier charges higher prices to those grocery wholesalers and retailers without buyer power as a direct result of the lower prices it charges to those grocery retailers with buyer power. The Association of Convenience Stores (ACS) submitted a detailed economic model setting out how the waterbed effect might lead to higher prices on average for customers and thus leave customers, as a whole, worse off. We are still in the process of reviewing the details of this theoretical model but we consider that it provides a rationale for the existence of a waterbed effect, which may lead to consumer harm.
116. The assumptions underlying the ACS model are set out in the working paper on buyer power. A key assumption is that the size of the grocery retailer determines its ability to obtain non-cost-related discounts and that differences in this respect

between small and large grocery retailers are significant. A preliminary analysis of price data for 15 suppliers of major branded goods does not indicate the presence of price differentials that are consistently in favour of the larger grocery retailers.³⁸ Going forward, we will seek to review additional data for other suppliers. Our survey of suppliers suggests that a waterbed effect might be observed more in relation to non-price factors, such as security of supply.

117. In the next stage of our investigation we plan to review further the details of the ACS model and further assess evidence relevant to the assumptions underlying this model. We invite participants in the investigation also to review the model advanced by the ACS and to submit comments on its validity and plausibility.

Investment and innovation

118. Retailer buyer power may have the effect of suppressing new investment or innovation if it reduces suppliers' expected returns from investment or innovation. This, in turn, may cause fewer new products to become available to consumers or to otherwise limit the range or nature of the products offered by suppliers. A number of suppliers have also put to us that the sale of own-label products by grocery retailers has reduced the incentive for branded goods suppliers to engage in product innovation.
119. The evidence on research and development (R&D) expenditure that we review in the working paper on buyer power does not indicate any significant decline in this expenditure in recent years. For example, ONS data reveals that aggregate R&D expenditure in food-producing businesses has increased since 1996. Further, the GfK supplier survey shows that 80 per cent of suppliers claim to have conducted

³⁸This is in contrast to the findings of the 2000 investigation where the then five largest grocery retailers (Asda, Safeway, Sainsbury's, Somerfield and Tesco) were found to purchase goods from suppliers at significantly lower prices than other grocery retailers.

some form of process or product development investment during the past two years. Of these, 43 per cent stated that they currently spent more on such investments than they did five years ago, while only 14 per cent stated that they spent less.

Demand withholding

120. Where upstream markets are fragmented and unit production costs increase with volume, grocery retailers might buy less (withhold demand) so as to reduce the price paid to suppliers. These circumstances seem more likely to be met in the case of fresh produce, where seasonal factors may be at work, compared with food and drink manufacturers where economies of scale are likely to be prevalent. If grocery retailers have market power, they can resell these reduced volumes at an increased price.
121. We have received evidence in relation to two primary products that might be consistent with demand withholding. However, further analysis is required before we are in a position to reach a view. Going forward, we will continue to look at upstream markets for possible evidence of demand withholding. We invite suppliers in markets where demand withholding may be taking place to come forward with evidence.

Supply chain practices

122. As set out in paragraph 101, a number of practices of grocery retailers have been brought to our attention during the inquiry. These include unilateral changes to contractual provisions, payments by suppliers to grocery retailers, the provision of category management and other marketing support services to grocery retailers, exclusive purchasing and dealing arrangements, the stocking of own-label products by grocery retailers, and the use of recommended retail prices. We review in the working paper on supply chain practices the likely competitive effects, as well as the evidence that we have received to date, of these practices.

123. We have received some submissions concerning unilateral changes to contracts by grocery retailers and instances of investment being undertaken by suppliers under an expectation of future orders from a grocery retailer that do not eventuate. It is difficult to judge how widespread such behaviour is purely from the number of submissions. Further, we note in paragraph 72 that suppliers have told us that they are not willing to come forward with evidence for fear of retaliation by their main customers. However, given that suppliers' incentives to innovate and invest may be adversely affected by a lack of certainty, we might expect this to be reflected in overall investment and R&D expenditure. Our review of R&D expenditure (see working paper on buyer power and paragraphs 118 and 119 above) does not indicate any reduction in product development investment in recent years. However, we intend to look at supplier investment further in the period leading up to provisional findings.
124. Our survey of suppliers indicates that supplier payments to grocery retailers, category management and exclusive purchasing and dealing arrangements are present in the industry. In our working paper on supplier practices, we consider the potential pro- and anti-competitive effects associated with these practices as well as the stocking of own-label goods and recommended retail prices. Going forward, we will further assess the evidence that has been provided to us so as to reach a view on whether these practices may be having an adverse effect.
125. In the context of bringing various supply chain practices to our attention, a number of parties have submitted that these either represent breaches of the Supermarket Code of Practice or that the Code of Practice should be tightened such that these practices are prohibited under the Code. The concept of 'reasonableness' in the Code, as set out in paragraph 70, means that simple presence of many of these practices does not indicate that the Code has been breached. Our survey of

suppliers, however, indicates that many of the practices addressed (as opposed to prohibited) under the Code are widespread.

126. We would note that any steps to tighten the Code as a result of this investigation are dependent on us finding the presence of one or more features that restrict, prevent or distort competition that are relevant to the relationship between grocery retailers and their suppliers.

Market structure and conduct

127. The second issue that we have identified as most relevant to our investigation, as set out in paragraph 99, is the structure of any local market for groceries and the conduct of grocery retailers and consumers. This section sets out some initial analysis of fascia choice for urban and rural consumers and also our current thinking in relation to price and non-price competition between grocery retailers. This, together with our working paper on pricing practices, represents the first steps in what will be a major exercise during the next stage of our investigation.

128. We will be looking closely at the extent to which price and non-price variables are influenced by the number and identity of grocery retailers in different local areas. To this end, we have collected extensive data from grocery retailers that will be subject to a systematic quantitative analysis. We may also undertake a number of case studies to look in more detail at how competition has taken place in practice in specific local areas.

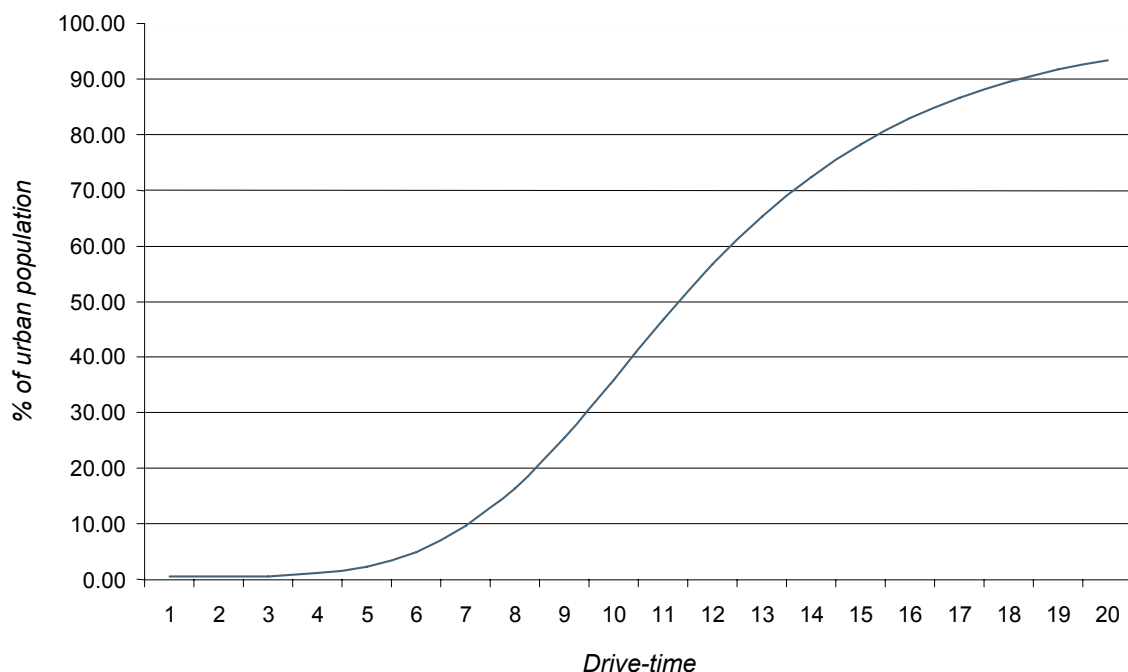
Consumer choice between grocery retailers

129. A preliminary analysis shows that only 35 per cent of the urban population in the UK has a choice of at least three different grocery outlets larger than 1,400 sq metres within a 10-minute drive-time (see Figure 3). If the drive-time is increased to

15 minutes, then 80 per cent of the urban population has a choice of at least three different grocery outlets larger than 1,400 sq metres. For rural areas, our analysis shows that less than 5 per cent of the rural population has a choice of at least three different grocery outlets larger than 1,400 sq metres within a 10-minute drive-time, and that if the drive-time is increased to 15 minutes, then 24 per cent of the rural population has a choice of at least three different grocery outlets larger than 1,400 sq metres (see Figure 4).

FIGURE 3

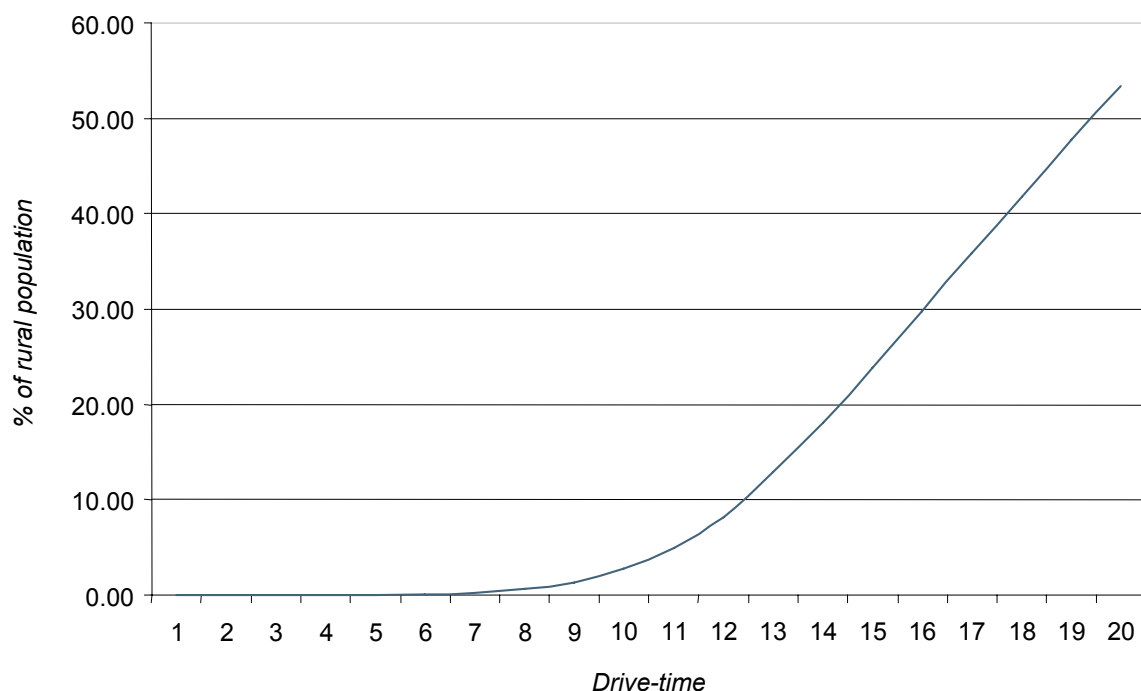
Proportion of the UK urban population with a choice of three grocery outlets each with a different fascia and larger than 1,400 sq metres



Source: CACI analysis of parties' data submissions and CACI retail store database.

FIGURE 4

Proportion of the UK rural population with a choice of three grocery outlets each with a different fascia and larger than 1,400 sq metres



Source: CACI analysis of parties' data submissions and CACI retail store database.

130. Going forward, measures of consumer choice will need to be brought into line with our definition of the relevant product market, and in particular, any differentiation between product markets in terms of store size and retailer type. We will examine the effectiveness of competition in different local areas and its relationship to the number and type of competing grocery retailers.

Price-based competition

131. Our assessment of price-based competition between grocery retailers in the UK focuses on two specific pricing practices that may be of concern:
- (a) below-cost selling; and
 - (b) price flexing.

132. The following paragraphs discuss each of these issues and further details of our analysis are contained in our working paper on pricing practices.

Below-cost selling

133. In general, we would expect consumers to benefit from lower prices, but below-cost selling may raise concerns if:

(a) it is part of a predatory strategy aimed at excluding rivals;

(b) it unintentionally leads to smaller grocery retailers or specialist stores exiting and has a harmful effect on consumers; or

(c) it misleads consumers into thinking that the prices of all products sold by a grocery retailer are lower than is really the case.

134. Our review of the below-cost selling practices of grocery retailers over the past 12 to 18 months shows that ten grocery retailers (Aldi, Asda, the Co-op,³⁹ Lidl, Morrisons, Netto, Sainsbury's, Somerfield, Tesco and Waitrose) engage in below-cost selling to varying extents. This represented, by sales value, up to 3 per cent of total revenue for these retailers. For most of these retailers, the majority of below-cost sales were in two or three product groups. The main product groups in which items are sold below cost are dry groceries (tinned and packet goods) and alcohol. Other product groups in which items are sold below cost include CDs, DVDs and books, non-alcoholic beverages, confectionery and health and beauty products. There was no clear relationship between the extent to which branded or own-label goods were sold below cost.

135. The reasons provided by grocery retailers for selling certain products at less than cost were consistent with those provided in the 2000 investigation. That is:

³⁹The Co-op in this regard refers to the Co-operative Group (CWS) Limited and some, but not all, independent co-operative societies.

- (a) there are certain products on which the parties would not be beaten on price, either because of a price pledge or because they wished to maintain a certain price differential between themselves and their competitors;
- (b) a desire not to sell their 'cheapest on display' items for more than their competitors;
- (c) there are certain periods of the year, such as Christmas, where products might be used as loss leaders to tempt customers into the store;
- (d) some seasonal products such as fresh fruit may be sold below cost at times when stocks are greater than that necessary to meet customer requirements;
- (e) increases in costs have not been reflected in the sales price; and
- (f) there are a small number of high-profile branded products, which are the subject of intense price competition.

136. Whether below-cost sales are predatory should take into account:

- the extent of sacrificed profits (the greater the profit sacrifice, the harder it will be to recoup as part of a profitable predatory strategy);
- the extent to which the target of any predatory activity constrains the prices of the firm engaging in predatory activity (as it only makes sense for the predator to remove or weaken a competitor that threatens its customer base);
- the structure of the market were predation to be successful (the predator must be able to increase prices so as to recoup forgone profits); and
- the nature of barriers to entry in the market (as this will influence the extent to which the predatory firm is able to increase prices).

137. Our current thinking is that larger grocery stores constrain the prices of smaller grocery stores, but that smaller stores do not constrain the prices of larger stores (see paragraph 93). As a result, we do not consider it likely that the large stores operated by the major grocery retailers would be able to recoup sacrificed profits

from a predatory strategy aimed at smaller grocery retailers or specialist stores. This is because, absent collusive conduct, the major grocery retailers would also have to eliminate competing large grocery retailers as well before being able to increase prices and recoup profits.

138. However, it is possible that smaller grocery retailers and specialist stores do constrain the smaller stores operated by the major grocery retailers. In this case, and if the major grocery retailers can minimize the profit sacrifice by varying prices according to the location of a store (eg through the use of vouchers or coupons), then a predatory strategy towards these stores may be feasible. In the period up to the publication of our provisional findings we will assess specific individual allegations that have been made and the likely effect of any predatory strategy on entry deterrence.

139. The exit of smaller grocery retailers and specialist stores may be an unintended consequence of below-cost selling rather than part of a predatory strategy. This is because major grocery retailers may be able to sell some products below cost due to their ability to sell other products at higher prices. Smaller stores typically sell fewer products and so are less able to support a below-cost selling strategy. Further, some of the products that are typically sold below cost, such as alcohol, may be particularly important sources of revenue for these smaller retailers. The exit of smaller retailers as a result of this below-cost selling would reduce the number of stores at which consumers could choose to shop. This has the potential adversely to affect consumers.

140. It is possible that consumers are misled by below-cost selling into thinking that products sold by the grocery retailer in question are cheaper than they are in reality. The evidence we have seen shows that consumers' price comparisons between

different grocery retailers are complex and depend not only on individual product prices but also on the basket price and other factors. In the period leading up to the publication of our provisional findings we will further assess the relevant evidence in this area and we invite submissions in relation to these matters.

Price flexing

141. Price flexing refers to the practice of grocery retailers of varying prices between stores. Asda, Morrisons, Sainsbury's and Tesco each have national price lists, other than for fuel, for goods that are not discounted but all adjust their offering at the local level. However, these local adjustments are small in the context of total grocery revenues. A number of other grocery retailers, however, have explained that they set their store prices according to the local level of competition.
142. We have heard a number of concerns regarding the discriminatory pricing practices of the major grocery retailers. The ACS submitted that this might be harmful to consumers and was evidence of a lack of effective competition.
143. In the period leading up to provisional findings, we will be undertaking a rigorous assessment of the extent to which prices, and non-price factors, vary between stores, and the extent to which any price variation may be related to a lack of effective competition.

Non-price competition

144. Grocery retailers may compete locally on factors other than price. Retailers may price products nationally but adjust their product range according to local competitive conditions. A number of retailers told us that product ranges varied locally according to competitive conditions. Grocery retailers may also vary the level of service at a store, for example the number of checkouts that are open or the number of staff

stocking shelves. Non-price competition in the form of store refurbishment or extensions also may take place, particularly in the context of responding to new entry.

145. Going forward, we will be assessing the extent to which grocery retailers vary their offer according to local factors, including the number and identity of competitors in the area. This will include an assessment of whether there is evidence that grocery retailers vary the quality, range and service at a store according to local conditions.

Planning and land use

146. The third issue that we have identified as most relevant to our investigation, as set out in paragraph 99, is the operation of the planning regime and the acquisition, disposal, development or use of land by grocery retailers. Our working papers on planning issues and on land holdings and use issues each address the issues discussed in the paragraphs below in further detail.

147. Our consideration of planning issues falls into two main areas:
- (a) the impact of specific planning policies and rules, such as the town centre first policy and the 'need test', as well as the overall complexity of the planning system (planning rules); and
 - (b) use of the planning system by grocery retailers as a means of gaining a competitive advantage (use of the planning system).

148. Our consideration of land use issues also falls into two main areas:

- (a) the impact of supermarkets' land holdings or 'land banks'⁴⁰ on future sales volumes and, possibly, the extent of their buyer power (land banks and national sales share projections); and
- (b) land transactions in local areas as a means of impeding entry (land use as a strategic device to impede entry).

149. We discuss each of these four issues in turn below.

Planning rules as a barrier to entry

150. Two key aspects of the planning system that are of particular interest in terms of acting as a potential barrier to entry into grocery retailing are:

- the rules and policies aimed at prioritizing town centres over other locations for retail development; and
- the rules and policies, including the need test, aimed at matching new investment with retail demand in a particular area.

151. The details of these arrangements vary across England, Scotland, Northern Ireland and Wales although the underlying principles are present in each jurisdiction.

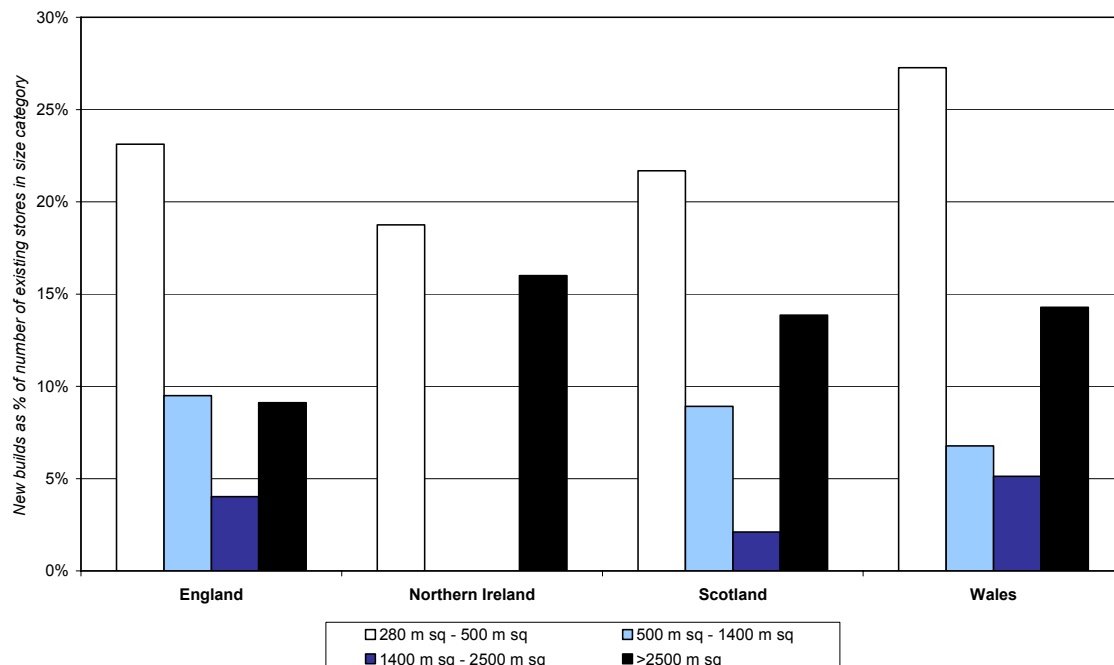
152. The planning regime's prioritization of town centres for retail development might be expected to have resulted in newly-built stores over 280 sq metres generally being smaller given the likely greater prevalence of smaller development sites in town centres. Since 2001, the development of newly-built stores as a proportion of existing store numbers has been greatest in stores sized 280 to 500 sq metres, particularly in England. This is also the case in Scotland, Northern Ireland and Wales; however, in

⁴⁰Different grocery retailers use different terms to describe their land holdings. For the purposes of this paper, we have adopted the term 'land bank' to describe land holdings that may be used to develop additional retail space. Further detail on how we have defined and measured grocery retailers' land banks is contained in the working paper on land holdings and use issues.

each of these three jurisdictions the growth of stores larger than 2,500 sq metres is also significant (see Figure 5).

FIGURE 5

Newly-built stores as a proportion of stores, by size, 2001 to 2006



Notes:

1. Calculation is number of stores in each size category built between June 2001 and September 2006 as a percentage of existing stores in that size category at September 2006.
2. Excludes stores acquired by grocery retailers through acquisition.

Source: CC calculations based on data provided by grocery retailers.

153. The lack of a quantitative need test in Scotland,⁴¹ compared with England, Northern Ireland and Wales, does not appear to have resulted in a greater proportion of newly-built supermarkets being in larger size categories. This appears to suggest that the need test, by itself, does not represent a constraint on the construction of larger supermarkets.

154. The extent to which town centre prioritization and its impact on new store development represents a barrier to entry into the product market for grocery retailing, however, depends at least in part on our more general analysis and

⁴¹Retail need may, however, form part of the qualitative assessment in Scotland.

conclusions, and in particular, any size-based delineation of the relevant product markets. In the period leading up to the publication of our provisional findings we will continue to examine the link between planning rules and the development of new stores and we welcome any further evidence in relation to this.

155. Several grocery retailers submitted that the duration and complexity of the planning process represented a barrier to entry (see paragraphs 44 to 48 of the working paper on planning). The responses made to our local planning authority questionnaire indicates that at least some of this delay may be a result of development submissions being made that are not in accordance with local development plans and with limited consultation with the planning authority.

156. However, we also note that there are significant differences between England, Scotland, Northern Ireland and Wales in the time required to achieve planning approval. In Wales, the time required to obtain planning approval for a retail development is significantly less than in any of the other three jurisdictions. Going forward, we intend to look further at reasons for these apparent differences between jurisdictions in the time required to obtain planning approval. We would welcome further evidence in relation to this.

Use of the planning system to gain a competitive advantage

157. Many parties have made submissions to us concerning individual planning applications and proposed store developments. We are, where it is feasible for us to do so, investigating the issues surrounding some of the individual planning applications that have been brought to our attention. These submissions have also been helpful in drawing to our attention the ways in which grocery retailers might seek to gain a competitive advantage through the planning system.

158. Issues that have come to our attention include:
- grocery retailers objecting to competitors' planning applications;
 - the use of section 106 agreements, which allow 'planning gains' proposed by a developer to be taken into account in the decision to grant planning approval;
 - the submission of applications for store extensions in response to competitors' applications for new stores;
 - the threat of appeal against local planning authority decisions; and
 - the lobbying and influencing of local government decision-makers by grocery retailers.
159. Our review of grocery retailers' use of these tactics (see working paper on planning) does not indicate, at this point, that the use of these tactics is systematic or widespread. Certain individual grocery retailers, however, may be more inclined to object to, or submit applications for, store extensions, in response to competitors' planning applications, or pursue section 106 agreements as part of proposed developments.
160. We would welcome further evidence in relation to the practices that we have identified or in relation to other practices by grocery retailers in relation to the planning system that may have an adverse effect on competition between grocery retailers.

Land holdings and projections of national sales shares

161. Several parties, including Friends of the Earth and Sainsbury's, submitted to us concerns about the size of individual grocery retailers' land banks. One specific concern was that Tesco's land holdings would facilitate an increase in its share of national grocery sales to 43 or 45 per cent over the next few years.

162. Based on our working assumption that the geographic market is local, rather than national, a grocery retailer's share of national sales is not necessarily a matter of concern in itself. However, given that our view on local geographic markets is only a working assumption, we remain interested in national shares of grocery sales. Moreover, to the extent that grocery retailers' land holdings and acquisition plans provide information about future sales volumes nationally, this may be of relevance when assessing the degree of buyer power possessed by different grocery retailers.
163. Our analysis shows, as is commonly supposed, that Tesco has the largest land bank both in absolute terms and as a proportion of existing retail space. Of the other grocery retailers whose land holdings we have analysed (Asda, Morrisons, Sainsbury's, Somerfield and Waitrose), several also have land holdings that are a significant proportion of their existing retail space. Taking into account pending acquisitions, we anticipate that Tesco will continue to have the largest land bank of the major grocery retailers for the foreseeable future, although certain other grocery retailers are in the process of acquiring significant amounts of land. We will be considering further the implications of this for market structure and conduct as well as supply chain issues.
164. Based on existing land holdings, pending land acquisitions and proposed developments as well as a range of other assumptions covering matters such as the existing ratio of grocery sales to land area, and recent sales trends for smaller grocery retailers,⁴² we have developed two sets of projections for future national shares of grocery sales for the four largest grocery retailers. These projections do not show Tesco's share of national sales increasing to 43–45 per cent. Our projections do, however, show some increase in Tesco's share of national sales over the period until 2011 with the extent of that increase varying according to the assumptions that

⁴²See working paper on land holdings and use issues for further details on these assumptions.

are made. For the other three major grocery retailers (Asda, Morrisons and Sainsbury's), our projections vary. Further details of our analysis are contained in our working paper on land holdings and use issues. Again, we shall be considering the implications of these projections.

Land use as a strategic device to impede entry

165. In relation to local markets for groceries, land holdings or other land transactions have the potential to be used to protect a grocery retailer where it already has a strong competitive position. There are a number of indicators of whether a grocery retailer might be behaving this way, in particular:

- a grocery retailer's land holdings might be concentrated in those areas where it already has a strong presence (so as to impede entry into these areas by competitors);
- a grocery retailer might take longer to develop its land holdings in those areas where it has a strong local presence (consistent with a buy-and-hold strategy aimed at preventing entry by a competitor);
- a grocery retailer might be willing to outbid competitors for land that becomes available in those areas where it has a strong presence (assuming it was making unusually large profits in those areas where it had a strong market presence); and
- a grocer retailer might put in place restrictive covenants on the use of any land that it sells in those areas where it has a strong market presence.

166. In the next stage of our inquiry, we will be looking at the relationship between grocery retailers' land holdings and their existing retail outlets. In relation to the other factors set out in paragraph 165, we are also not yet in a position to relate, for example, the use of restrictive covenants on land sales by individual grocery retailers to their presence in different local markets. We anticipate conducting this analysis in the period leading up to the publication of our provisional findings. It is possible,

however, to make some general comments regarding these other factors based on nationally aggregated data.

167. Regarding land-holding times, three of the four largest grocery retailers appear to submit planning applications significantly more quickly than the remaining grocery retailer. However, this difference in timing may reflect a greater involvement by this retailer in the assembly of development sites from individual land parcels rather than strategic land acquisition aimed at deterring entry by competitors.
168. In terms of restrictive covenants, around 12 per cent of all land sales by grocery retailers for which we have collected data (Aldi, Asda, Iceland, M&S, Morrisons, Netto, Sainsbury's, Somerfield, Waitrose, Tesco) involved the use of a restrictive covenant. This figure was also 12 per cent for the four largest grocery retailers. The frequency with which individual retailers use restrictive covenants varies from zero to, in the case of one retailer, more than 50 per cent of all of its land disposals for which we have the relevant data.
169. Going forward in relation to land issues, our intention is to look in much greater detail at grocery retailers' land holdings and pending acquisitions relative to their presence in different local markets. We will also look further at the practices discussed above to see whether their incidence is related to grocery retailers' presence in local markets where their competitive position is stronger. We also intend to look at the financial incentives for different land-holding strategies to assist us in understanding the financial implications of these different strategies.