Summary of Second hearing with Morrisons held on 19 June 2007

Background

1. Morrisons considered food to be its core business and that, whilst it offered non-food items which could comfortably be sold along with the weekly food shop, it had no present intention to move into 'big-ticket' non-food items or clothing ranges. This was reflected by the size of stores which it operated; the largest of which (other than a few larger exceptions) were around 3,700 sq metres (40,000 sq feet). A much larger selling area was necessary to enter non-food more seriously. Morrisons' vertical integration with food factories and processing units added to its strength in food and this is where it continued to focus.

2. Historically, Morrisons had concentrated on stores around 3,700 sq metres. However, it said that the acquisition of Safeway had given it a wider range of stores and it now operated stores from 1,400 to 2,325 sq metres (15,000 to 25,000 sq feet) which it had found it could operate very effectively. This meant that it was now being more flexible in the sites that it was looking to acquire. It did not, however, anticipate entering the convenience sector.

3. Its range varied according to local demographics, regional preferences and store size. It had one single national pricing policy, save for fuel where it aimed to price at least as low as any local competitor.

The market, pricing and competition

4. Morrisons said that it visited all new stores that opened near its existing stores. It responded to local entry by bringing forward any planned refurbishment and/or by adding or expanding departments to ensure that its store was equipped as well as was possible to compete with the new store. It did not implement price flexing; and whilst it recently announced a segment-based approach, this was confined to its range and not price, quality or service, where it aimed to operate to consistently high standards. It remained committed to a national pricing policy which it considered efficient to its business.

5. It believed that people shopped locally and chose from the stores within a 10- to 15-minute drive time. It defined the competitive neighbourhood for petrol with the same drive time. It believed that the national strategies of national operators had a great influence on what happened locally; indeed most of what happened locally was decided nationally.

6. Its retail prices were set, primarily, with reference to the cost price. However, it also monitored prices at its competitors' stores, particularly looking at pricing at Sainsbury's, Asda and Tesco and also in the limited range discounters. It did not regularly monitor pricing in Marks & Spencer or Waitrose. It told us that price moves were often a response to changes in cost from the supply base. If competitive activity increased due to short-term product promotion, it tended not to react as if the product was a national brand, Morrisons would no doubt have a planned promotion period for that product at another time which helped balance the supplier's production facilities. If the product was a Known Value Item (KVI) and a competitor had apparently reduced the price for a longer period of time, Morrisons could not afford to be out of line and would respond accordingly.

7. The elements of competition—purchasing, product range, range of own-label products, store format, branding and most advertising, new openings, distribution, in-

store marketing, promotion, service and ethos—were some of the strategies that were developed nationally and these had a great effect on how competition took place locally.

8. The 6 per cent price inflation across the industry shown in a recent study to some extent reflected historically lower prices in the UK than in Continental Europe. The industry over the past few years had been particularly competitive and therefore prices had been driven to a level that was lower in the UK than on the Continent. Suppliers had been pushing hard to increase cost prices and Morrisons had in some instances passed this increased cost to its customers. Morrisons' inflation was currently circa 4 per cent and also reflected trading-up on products, with customers being prepared to pay more for premium quality products.

9. Morrisons believed that the retailer share of local markets and national market shares were both very important. To the extent that one company became too dominant in the national marketplace, consumers would eventually suffer as competition became less intense. Morrisons believed that a fascia test should be introduced into the planning process similar to the one used at the time that Morrisons acquired Safeway. Competition was indeed very intense today but there were clear signs of increasing dominance, and accompanying arrogance towards the authorities, from the dominant player.

Land and planning

10. In respect of planning, the shortage of suitable sites (ie land with appropriate potential for development and a reasonable prospect of obtaining consent) was a serious constraint on Morrisons expanding its business. This was a product of the planning regime. The rise in value of residential land meant that Morrisons found itself competing with developers of residential property and non-food retailers, as well as other food retailers. These alternative uses might generate higher value. It had not experienced particular difficulties resulting from restrictive covenants imposed by others, save in Enfield (where it had resolved the issue with Safeway) and the company had imposed some itself; seven where it disposed of land and three where it had acquired land.

11. It preferred to take the lead as a developer so that it had better control of the costs. This did, however, run the risk of progressing the planning application and the scheme and potentially having to sell the land at a loss if the planning application was unsuccessful. It had, in the past, developed whole town centres in order to get a supermarket site which was usually compensated by lower overall costs. It did consider there to be a scale threshold but believed that Morrisons was over it. However, it noted that the bigger a supermarket chain was, the more risk it could take.

12. The Competition Commission's (CC's) proposed definition of land bank and treatment of land holdings caused Morrisons concern and a site by site explanation of the various reasons for land holdings at a point in time was the appropriate way to deal with this issue.

Supermarket Code of Practice

13. The discussion continued covering some of the supply chain practices that the CC listed in its 2000 report. However, Morrisons emphasized that its conduct was within the terms of the Supermarket Code of Practice (SCOP) (introduced to reflect the 2000 Report)—even though it was not within its scope until March 2004. The SCOP distinguished between reasonable 'requests' and a 'requirement'. A supplier's

response to requests would depend on the reasonableness of the request and the ‘strength’ of the supplier in the normal relationship that existed between buyer and supplier. When dealing with primary brands, this was weighted towards the supplier, but when dealing with tertiary brands, the balance could be weighted towards Morrisons.

14. Morrisons believed that the SCOP should be extended to all grocery retailers and to processors’ relationships with primary producers. It gave its buyers a copy of the SCOP and trained them in its application. It told us that its buying responsibilities were by product category; so with Proctor and Gamble there would be one buyer who looked after soap powers and detergents and someone else in charge of health and beauty categories and another managing batteries. Super-imposed on this structure was a trading manager who would be looking after the total account and monitoring how individual product ranges were developing, agreeing the overall deal and developing the annual supplier business plan.

The supply chain

15. Morrisons’ buyers were not incentivized on gross margin achievement and their performance was appraised beyond cost price/margin and included quality aspects, range, and product category development. Buyers were not rewarded on the additional income that was brought into the company through their negotiations but received a salary with profit share, which was based on total company performance. A buyer might have a very good reason for not achieving their targeted gross margin, for example where a competitor had slashed the price of key products in the area of product responsibility. The buyer would not be penalized for this.

16. Morrisons’ business was basically sustained on the gross margin 52 weeks of the year, and whilst retrospective annual rebates were important, they were not as important as earning a sensible gross margin on a daily or weekly basis. It was important for buyers that the products for which they were responsible were purchased competitively, so that they could both make a reasonable gross margin whilst being competitively priced at retail level.

17. For the CC to understand the net product cost, it was important to understand all the income that flowed to the retailer from the supplier base. Invoice prices would often reflect a volume relationship and there would not be as much variation in the other income inflow where a supplier was small relative to major branded suppliers.

18. Morrisons was confident that it could maintain its supplier base over the medium to longer term. It considered that it was fair for the CC to conclude that the market could be characterized by an increasing focus on primary brand and own label and less exposure for secondary and tertiary brands. It considered this to mean that the marketplace was working properly. When tertiary brands gained in popularity, they became known brands which its customers would expect a retailer to stock. Morrisons said that tertiary brands had often been replaced by own label and own label had provided better competition to brands because they were better marketed, better packaged and therefore constrained branded product prices. Rather than this resulting in less choice for the consumer, the current range of products within its stores and those of its competitors meant that consumers’ choice had increased markedly over recent years.