

## **Summary of the hearing with Pareto Retail on 7 September 2006**

### **About Pareto Retail**

1. Pareto Retail is a member of the Association of Convenience Stores. It was formed about ten years ago with the acquisition of a single shop, with the ambition of developing a retail chain by a process of organic growth augmented by suitable acquisitions.
2. Also represented at the hearing was the owner of a number of independent retail stores in the North-West under the Bargain Booze franchise and Nisa Todays name. Bargain Booze is an alcohol wholesaler with retail franchisees. As well as supplying alcohol on a wholesale basis to its franchisees, it also supplies them with a closed loop EPOS/back office system. There are uniform retail prices and promotional activities across its franchisees other than under exceptional circumstances.

### **Market conditions**

3. Pareto Retail stated that the UK grocery market had failed and that its preferred strategy was to put all future investments on hold until the issue was resolved.
4. Pareto Retail stated that larger retailers were not necessarily more efficient than smaller retailers, despite the economies of scale and buyer power of the larger retailers. Pareto Retail contrasted the typical floor area in one of its off-licences of about 46 sq metres (500 sq feet) with the alcohol aisle in a supermarket which could be about 93 sq metres (1,000 sq feet) in size, of a total supermarket floor area of the order of 2,787 sq metres (30,000 sq feet). Pareto Retail told us that the rents that it paid for its off-licences on secondary sites, which were an indicator of the capital cost of each retail unit, compared favourably with the development costs for supermarkets, and that turnover per sq foot was similar or better in its off-licences than that achieved by the supermarkets. Pareto Retail noted that the efficiency of its off-licences allowed it to operate viably with a gross margin that it estimated was about half the gross margin taken by supermarkets. It also noted that the financial pressure on smaller retailers as a result of the exercise of buyer power by the larger retailers could have the effect of forcing the smaller, more efficient retailers, out of business.
5. Pareto Retail told us that, when the cost of advertising and promotions during key periods such as Christmas was taken into account, the profitability of some of Pareto Retail's stores became marginal, and that sales during the Christmas period were significantly lower than ten years ago. Pareto Retail told us that it was no longer the case that off-licence retailers made a significant proportion of their profits in December.
6. The independent retailer operating as a Bargain Booze franchisee stated that business had become more difficult and that turnover per store had decreased over the last few years. He told us that the supermarkets' share of off-licence sales had increased from about half of the market in the mid-1980s to up to 70 per cent by the mid-1990s, and that consumers' buying habits had changed in that they were buying alcohol in supermarkets and keeping their own stocks at home rather buying alcohol when needed as a convenience item.

### **Pricing**

7. The independent retailer expressed serious concerns about the supermarkets' retail prices for alcohol during promotions. He considered that the extent of discounting was

designed, or appeared to be designed, to drive rival independent retailers out of business. He also considered that the supermarkets advertised their discounts on alcohol in a somewhat misleading way to make them look better than they were.

8. Pareto Retail stated that the supermarkets appeared to be selling below cost whereas Bargain Booze did not.
9. Pareto Retail stated that the supermarkets appeared to be flexing prices locally in response to competitive intensity.
10. Pareto Retail considered that it was important that, when the Competition Commission looked into pricing and below-cost selling, it should consider the ultimate net price paid by retailers for products, taking into account all amounts paid by suppliers to retailers, including over-riders, sums for marketing support etc.

### **Entry and expansion**

11. Pareto Retail noted that there were about 50,000 independent convenience retailers (including members of symbol groups), with stores of typically between 93 to 186 sq metres (1,000 to 2,000 sq feet) and with turnovers of about £0.5 million to £1 million a year. Pareto Retail also identified a smaller group of independent supermarket retailers with larger stores. Pareto Retail considered that, if the market were operating well, there would be a ladder for entry and progression in the market, such that it would be possible for new entrants to come into the market as independent convenience retailers and to grow into independent supermarket retailers and ultimately, over time, become one of the major supermarket retailers of the future. Pareto Retail considered that the practice of price discrimination was removing this opportunity for entry and growth.
12. Pareto Retail explained that, ten years from the launch of a retail convenience store business, it was possible to envisage a ten-store business with around £10 million turnover in total. Such a business would have sufficient resources to have a head office function to develop its own brand. The business would need to purchase goods as competitively as possible from a buying group. Pareto Retail told us that the next step in the development of the business would be to increase store size from around 186 to 465 sq metres (2,000 to around 5,000 or more sq feet), allowing the sale of fresh produce from direct suppliers, a meat counter and possibly a coffee shop to be introduced. Pareto Retail considered that there were only of the order of 100 stores in the UK in this category. Pareto Retail stated that there was then a significant gap in the market between that category of retailer and the next category of supermarkets, which might have turnover ten times larger, and that the reason for this gap appeared to be the lack of equivalent buyer power for the smaller independent supermarkets.
13. Pareto Retail considered that the independent wholesale sector was struggling and was approaching a tipping point where the economics of the sector might disappear. Pareto Retail told us that it would be very difficult to rebuild the sector subsequently.

### **Buyer power**

14. Pareto Retail considered that the cost of producing and distributing mature products to both large and small retailers was similar, but that there was an 11 per cent or more difference in the prices charged by suppliers to the supermarket multiples and to smaller operators, reflecting the multiples' buyer power. Pareto Retail also told us that, in its view, the multiples used the threat of delisting to obtain discounts from their suppliers. Pareto Retail told us that that the Competition Commission should

investigate the possible existence of buyer power in relation to the big four supermarkets and also in relation to the European discounters entering the UK. It considered that, although these businesses might be competing with each other, they were not constrained by any retailers outside that group. Pareto Retail considered that Tesco, because of its greater market share and its potential—if it fully developed its land-bank—to acquire an even higher market share, was a particular concern to it.

15. Pareto Retail told us that it believed that the supermarkets' buyer power arose on a national basis, or possibly even a pan-European basis, as the supermarkets tended to procure on a national account basis, whereas the supermarkets' ability to price was more a function of local competitive circumstances. Whilst Pareto Retail acknowledged that supermarkets might in general have one price nationally for a particular product in a particular store format, it considered that there were significant examples of supermarkets departing from that overall policy, and that there was more price flexing, for example in Tesco's One Stop format. Pareto Retail told us that price flexing might arise more often in relation to 'known value items' such as milk.
16. Pareto Retail noted that it was difficult to know from the outside whether the low retail prices at supermarkets were the result of below-cost selling or were the result of the supermarkets being able to obtain cheaper prices than other retailers from their suppliers. Pareto Retail told us it was increasingly of the view that the supermarkets used higher margins on certain items, for example non-food lines, to subsidize below-cost selling on products such as fuel and alcohol, which served to draw customers into the supermarket. The work by the Association of Convenience Stores on very low retail prices for Easter eggs was also mentioned.
17. The independent retailer operating stores under the Bargain Booze franchise told us that its suppliers appeared powerless to stop the supermarkets selling their products below cost, and that the supermarkets appeared to have sufficient power to secure deliveries and ignore any recommendations for pricing. The independent retailer considered that it was more important to the supplier that the product was on the supermarkets' shelves rather than that its price was maintained.
18. Pareto Retail noted that the constraints on pricing in convenience stores varied from one product to another. Some products that came from large suppliers with a large market share will be priced at the supplier's recommended retail price but may deliver a low margin. Prices on known value items cannot be increased without harming the business, but higher prices (and margins) can be achieved on other products.
19. The independent retailer operating stores under the Bargain Booze franchise told us that it was possible for smaller retailers to compete on non-price elements such as convenience, better service and offering a more pleasant shopping environment, but that there was limited scope for this and these retailers still required sufficient turnover to be viable, which they had to achieve through higher prices.

### **Supermarkets and convenience stores**

20. Pareto Retail told us that, in its view, only the large multiple retailers were making sufficient returns to be able to acquire or develop the convenience retail stores/sites that became available. Pareto Retail considered that this indicated that supermarkets would continue to move into the convenience sector and use their buyer power in that sector as well, because it would not be economically viable for anyone else to do so.
21. Pareto Retail told us that, when Tesco's One Stop convenience stores were compared with a representative group of independent convenience stores, Tesco's prices were higher and their range and store standards were not necessarily any better. Pareto

Retail considered that, whilst Tesco was able to use its buyer power to purchase products such as milk cheaply for supply to all its different store formats, its prices were different in different store formats with significant mark-ups in its convenience store formats. In Pareto Retail's view, this indicated that the benefits of Tesco's buying power were not being passed on fully to consumers.

### **The supermarket code of practice**

22. Pareto Retail considered that the code of practice had had no practical impact, and that the large supermarkets were able to exploit their power over their suppliers regardless of the code.
23. Pareto Retail and the independent retailer operating under the Bargain Booze franchise suggested that the Competition Commission might wish to consider requiring transparency in the wholesale market, and requiring that like quantities of goods were supplied at the same cost to all parties. Pareto Retail characterised this as 'equality of buying opportunity'. Pareto Retail also considered that only small price differentials could be justified on the basis of volume, since most retailers had implemented highly efficient, best practice logistics arrangements and purchased at the most economic level of volume, namely the full trucker load.
24. Pareto Retail told us that the effect of a prohibition on price discrimination would mean that prices paid by consumers who wished to buy locally would be reduced, and that there might be a small increase in prices for consumers who had, to date, enjoyed the full benefits of unrestrained price discrimination by shopping at supermarkets.
25. Pareto Retail also mentioned other measures such as prohibitions on below-cost selling and price flexing via couponing, as well as dealing with defects in the planning system as described by other parties, including taking into account market shares and need for new retail developments in planning decisions.