

## Summary of main party hearing with Tesco held on 20 June 2007

### Industry trends

1. Tesco noted that UK consumers appeared to be shifting expenditure towards food, owing to concerns about diet and health issues. It also believed that Office for National Statistics (ONS) estimates of food price inflation were overstated, and that current food price inflation was a little over 2%, rather than the 6% recorded by the ONS.

### Working Papers

2. Tesco told us it was concerned that the working papers it had seen since the publication of Emerging Thinking did not appear to reflect the balance of evidence before the Competition Commission (CC). Although Tesco acknowledged that the CC saw the working papers as a 'technique' used to generate debate, Tesco was concerned that the working papers did not appear to recognize the intense competitive rivalry in the UK grocery retailing market. In particular, Tesco expressed concerns about the CC's working papers on market definition, which did not in Tesco's view reflect the evidence presented that day-to-day competition occurred between a wide range of retailers and overwhelmingly at the national level.

### Geographic Market Definition

3. Tesco agreed that, although internet shopping and workplace shopping were important at the margins, most customers shop locally. However, Tesco disagreed with the assertion that this meant the relevant geographic markets were local. Tesco noted that its SSNIP analysis suggested that 87 per cent of markets are at least thirty minutes wide, and that the catchment areas of these markets overlap. Tesco also said that its SSNIP analysis had made many conservative assumptions (which the CC had not described in its working paper on Market Definition). The Tesco assumptions, which the CC and others had suggested might have artificially widened the market, had all either been fully accounted for in Tesco's own modelling, or did not materially affect the outcome. Tesco provided the CC with the results of further sensitivity tests on its model to demonstrate this.
4. Tesco told us that all of its major decisions are taken at the national level, and contended that the price, quality, range and service ("PQRS") of the major retailers did not vary by location. It referred to the fact that it invests significant sums in reducing prices in response to competitors who are not present in many local areas, and told us that the vast majority of competitive interactions took place at a national level. Tesco referred to its evidence that its own PQRS levels did not vary, regardless of local levels of concentration, and to the GfK survey commissioned by the CC in relation to the same issue.
5. Tesco told us that its expenditure on local vouchering was [redacted] de

*minimis*, and represented less than [X] % of its total sales. Tesco explained that [X].

6. Local marketing activity was [X]. Tesco was aware that some smaller retailers claimed to have been affected by such promotions, but believed the evidence suggested that smaller retailers were competing well, and the better ones that had responded to changing customer needs were thriving.
7. Tesco submitted that the changes in margin identified by the CC in its margin-concentration working paper were not only *de minimis*, but were the result not of any competitive response to increased concentration but simply of a volume effect. This volume effect arose due to the presence of fixed costs in the CC's measure of margin, so that a reduction in sales (caused, for example, by the entry of a new store into a local area) reduced the margin of the existing store simply because the fixed cost element was spread over a smaller sales base.

### **Product Market Definition**

8. Tesco disagreed with the suggestion in the CC's working papers that stores had to be of a certain size in order to compete with one another. Tesco did not accept the proposition that, if a customer wanted to switch stores, it would do so only to one of a similar size. Tesco said that customers can and do carry out all types of shopping in all sizes of stores — for example, a significant proportion of revenue from Tesco Express stores came from "one stop shopping".
9. Similarly, Tesco believed the balance of evidence firmly suggested that a wide range of fascia were competing in the same product market, and noted its view that it competed against the limited assortment discounters (LADs), Marks & Spencer and other retailers, and that these retailers in turn believed that they competed with Tesco.
10. Tesco therefore submitted that the product market was therefore much wider than the one the CC had focused on.

### **Fuel pricing**

11. Tesco agreed that fuel was priced locally. It was a different product market to that for grocery retailing, and margins were very small (meaning Tesco had little ability to influence the retail price). There was a long tradition of having different prices in different locations, which historically had been due to different distribution costs. Customers were therefore inured to such price differences. The pricing policies of the oil majors were also an important influence on the structure of pricing in the fuel sector. This was unlike the situation in grocery retail, where marketing, branding and price promises all took place at the national level. Tesco told us that its fuel offer was not specifically designed to be a "loss leader". While there was a connection between promotional fuel vouchers and grocery purchases, this connection was very small. The vast majority of Tesco's fuel vouchering was conducted on a national basis.

## **Effect of non-grocery business on grocery retail**

12. Tesco explained that it was very difficult to assess the precise benefit to its grocery business of also having a non-grocery offer. Whether a mixed store would do better than a dedicated grocery store would depend on a range of factors, including the geography and demographics of the particular area. [X].
13. Overall, Tesco believed that its entry into non-food had been successful, as the sector itself had proven profitable for Tesco and had increased the markets to which it had access. Tesco believed customers had benefited from the expansion of its offer into non-food, where it had brought increased competition.

## **Effect of supermarkets on specialist grocery stores and convenience stores**

14. Tesco noted that while some specialist shops appeared to have declined in numbers, the rate of decline was less than in the past and indeed some sectors were thriving. Smaller shops that had adapted and responded to customers' changing needs were doing well. Others that had been unable to improve their service were struggling, as customers switched to retailers whose PQRS offers they preferred.
15. Tesco submitted that the CC's own working paper on the subject showed that this was a complex area. The fact that there was considerable 'churn' in many sectors reflected evolving, dynamic high streets that were responding to changes in society. Tesco was aware that others had asserted that high streets were in decline, but believed this was a pessimistic approach to the evidence. Tesco believed that the modern high street was better at delivering for customers — in terms of value, choice and service — than some commentators appeared to acknowledge. Moreover, large numbers of convenience grocery stores that had left the 'independent' sector had in fact joined symbol groups, and standards throughout the small and specialist grocery sector had been raised as a result of competition.
16. Tesco told us that it had used the Experian Goad database to analyse trends in convenience store numbers at the time of its acquisition of convenience store chains. While the database does not cover the entire country, it does cover high streets and district centres, and so is suitable for the purpose of assessing the effect of supermarket entry on convenience stores and specialist grocery stores. [X]. Tesco also noted that IGD has forecast significant growth in total sales by convenience stores in the period to 2011.
17. Tesco referred to evidence it had submitted that showed that when a modern food store opens in a town it can have a beneficial effect on other retailers in that town. The popularity of such stores can become a rejuvenating force, increasing footfall and custom for all local shops, and improving the vitality of the neighbourhood around the store. Tesco contended that the response of UK groceries retailers to the issue of 'food deserts' had been outstanding: Tesco and other multiple retailers had successfully brought their national PQRS offers to areas which previously had been considered too difficult or remote. As a result, the

UK now has one of the most consistent standards of retailing across local areas.

### **Retail competition and price setting**

18. Price cuts were driven by a range of factors, including seasonal effects and promotional changes. Tesco's decisions on the pricing of particular products tended to weigh both market factors (i.e. the position of competitors) and cost price considerations. If a competitor was able to achieve a cost reduction, perhaps through developing further efficiencies in supply chain logistics, then Tesco would look to match the retail price the competitor was achieving. However, it would be difficult to characterize such an investment in price cuts as either "cost driven" or "market driven", because there was not a clear dividing line between the two.
19. Tesco noted that the considerable efforts to stock up, to prepare "point of sale" material and to brief stores in relation to price changes all contributed to a situation where pricing was national, rather than local. It told us that while its IT systems might be able to cope with pricing at a local level, management could not (or certainly not at the granular levels contemplated in econometric modelling submitted by RBB). It believed consumers would resent prices being different in different catchments, and that national branding, advertising and media all meant national pricing was the only commercially sensible strategy.
20. Tesco noted that retail prices were very transparent, and that it had begun to publish price comparisons on the internet a number of years ago. Tesco monitored the retail prices of a wide range of competitors — many more than just the other major supermarkets. In some cases, rival retailers were moving from a strategy based on core prices to one based on promotions, although there had been general convergence in retailers' overall price levels in recent years when core prices and promotions were taken into account. The advent of the LADs had tended to pull the overall market price level in a downward direction.
21. Customers had benefited enormously from this competition, and were continuing to benefit all over the country. Prices had fallen, range, quality and investment had improved and innovation had increased. Tesco acknowledged that this was a painful, noisy, contentious process, but competition was doing its job. It submitted that any work by the CC at the local level should be set against that backdrop.

### **Planning**

22. Tesco believed that planning policy and legislation required retailers to adopt a flexible approach to site assembly and development. Tesco submitted that land was available for development, provided retailers were flexible enough to work with the grain of the planning framework. Tesco and some other retailers had done this, and so had been successful in developing sites which complied with the Government's town-centre-first planning policies. Tesco had always been a high street retailer, and had therefore been comfortable in developing different sizes

of stores. However, Tesco considered that some of its competitors, including Asda, had not been so flexible, and that - rather than adapt their approach to the UK's planning system - they had preferred to lobby for 'town centre first' planning controls to be relaxed.

23. Tesco noted that the planning regime was currently being reviewed by the Government, and that the Planning White Paper (following on from the Barker Review of Land Use Planning) suggested that the need test should be abolished. Tesco agreed that the need test was an unnecessary burden on business which was not needed to support town-centre-first planning policies, and would be pleased to see it removed. However, Tesco noted that the need test, like all other aspects of the planning regime, applied equally to all retailers and did not constitute an incumbency advantage or an insurmountable barrier to entry. Tesco thought that the biggest problem with the planning regime was that it was complex and inefficient, and operated too slowly.
24. Tesco believed a competition test would be entirely unnecessary, and would add to the complexity of the planning regime. Doing so would also run directly contrary to the White Paper's express aim of reducing the regulatory burden of multiple consent regimes, and would introduce consideration of factors which lie outside the realm of normal planning policy, so that planning authorities would lack expertise to apply such a test.
25. Tesco contended that PPS6 already provides for "genuine choice to meet the needs of the whole community", in terms of making sure there is adequate and sustainable retail provision for all of the inhabitants of a local area. This allows local planning authorities (LPAs) to give weight to competition issues, without imposing a rigid test. Suggestions that references to "competition" in PPS6 were interpreted by LPAs as competition between areas or district centres, rather than competition between rival retailers, were incorrect.
26. Tesco noted that those parties calling for the need test to be replaced by a competition test had claimed there was a shortage of suitable sites available for development. It said that those parties had made similar claims at the time of the 2000 CC inquiry, and yet had actually been able to expand significantly in the intervening period. Nearly 600 new supermarkets had opened since the CC inquiry in 2000 (including 380 LAD stores). Moreover, many UK grocery retailers had announced significant expansion plans for coming years.

## **Land holdings**

27. There were some instances where Tesco had not been able to progress a site through the planning system, but it told us that it developed its land pipeline as fast as it could. As such, Tesco submitted that there was no evidence that it engaged in strategic land holding.
28. Tesco imposed restrictive covenants in a small proportion of cases when selling a site. Its intention when imposing restrictive covenants on disposals was to ensure that it could capture any benefit stemming from subsequent retail development which took advantage of a change in planning prospects, or of infrastructure costs that Tesco had incurred in

developing the site. In Tesco's view, exclusivity arrangements in shopping centres played an important role in attracting anchor tenants and ensuring the market for retail land worked effectively. The certainty conferred by exclusivity arrangements can promote competition and development. Moreover, Tesco stated that restrictive covenants and exclusivity arrangements relating to land were regarded under the Competition Act as pro-competitive.

29. Tesco explained that there was no restrictive covenant in the high-profile case of Sheringham, contrary to what had been reported by some parties. The local council (as seller rather than as planning authority) has agreed not to promote another site for retail. This does not prevent another retailer from finding a site and securing planning permission for a supermarket.

## **Supply chain**

30. Tesco submitted that third party evidence showed that the supply chain "in the round" remains healthy, with investment and innovation taking place. It suggested that this accorded with the reality of the large number of diverse products on Tesco's shelves, and noted that its larger stores had seen a 40 per cent increase in product range over the past 5 years. Tesco submitted that UK grocery customers benefited from a vibrant and innovative supply chain – one of the best, if not the best, in Europe.
31. Tesco explained that it had recently put in place an arrangement with its milk processors, whereby approximately 850 farmers that supply Tesco with fresh milk will know that their milk is bought by Tesco, and Tesco will know the source of the milk. Tesco will also underwrite the price that these farmers receive for their milk. Previously, farmers had not known whether or not they were supplying Tesco (although there had still been complaints about the price they were receiving). Tesco suggested that milk was almost unique in this regard, due to the pool structure previously operated by the Milk Marketing Board. The arrangement had become possible in recent times due to capital investment by Tesco's main dairy suppliers, which facilitated the segregation of milk supplies by customer.
32. Tesco explained that regular turnover of buyers, and movement of buyers between product categories, was designed to develop human capital. It also prevented Tesco's relationship with particular suppliers being based on one individual buyer. Continuity in Tesco's relationships with suppliers was also preserved by category directors.
33. Tesco explained that it was not possible to track the way in which a particular price cut is passed through to the supply base, as they are not linked directly in this way. Tesco achieved its price cuts through continual refinement and improvement, and its efficiencies saved it some £[redacted] annually. Tesco noted that there were many more suppliers (particularly branded suppliers) requesting promotions of their products than Tesco was actually able to promote.

## Supermarket Code of Practice

34. Tesco believed the Supermarket Code of Practice (SCOP) had been useful in formalising Tesco's existing practices in its relations with suppliers, and considered that the SCOP could usefully be extended to processors and intermediaries. The SCOP ensured that any divergences from best practice would be easily recognized as such. It provided a clear framework for training Tesco's buyers, and had made the process of addressing suppliers' concerns more transparent and consistent. Tesco believed that the OFT's 2005 audit demonstrated that the SCOP was fully complied with by Tesco.
35. Tesco believed that many of the "practices" which it was sometimes alleged Tesco engaged in were not actually occurring. There were many assertions and unsubstantiated allegations about Tesco's relationship with its suppliers, and Tesco had hoped that the OFT's 2005 audit would put to rest some of the myths about the supply chain.
36. Tesco said it was frustrating and concerning that there continued to be assertions that there was a 'climate of fear', as well as other general allegations in relation to the supply chain. It did not deny that evidence from suppliers might demonstrate isolated incidents in which a buyer engages in practices to which the CC objects, but expressed its concern that allegations were made generally and without providing Tesco enough information on which to comment. If there were any such evidence, it should be put to Tesco. Moreover, it submitted that isolated incidents, in a market with many hundreds of thousands of retailer-supplier interactions every week, do not amount to a feature of the market. Tesco believed that many of the allegations were from people who either were not suppliers at all, or who were not suppliers to Tesco. Tesco strived to have cooperative, collaborative relationships with its suppliers, and would welcome a solution to the problem of unsubstantiated allegations that tarnished its reputation.
37. Tesco believed the evidence needed to be weighed against the assertions. The evidence suggested that manufacturing margins had grown, that more suppliers were entering the market than were exiting it, and that suppliers who had a genuine grievance about the conduct of a Tesco buyer could come forward and discuss their concerns. Tesco's internal policy was to treat breaches of the SCOP as though they were "unlawful".
38. Tesco told us that a very significant proportion of its supply base had sales of less than £[redacted] with Tesco, and that Tesco understood the economics of those businesses and helped them to grow. The feedback Tesco had from its own (independent and anonymous) surveys of its suppliers was overwhelmingly positive – the vast majority of suppliers surveyed found their relationships with Tesco to be "demanding but professional", and that working with Tesco had improved their business.