

Inquiry Secretariat
Groceries Investigation
Competition Commission
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Adrian Costain
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Dear Sirs

Grocery Market Inquiry – Pareto Retail Main Submission.

As a member of the ACS, Pareto Retail welcome the current Competition Commission Inquiry into the supply of groceries in the UK. As you will find in our questionnaire responses Pareto Retail is a relatively small company with a single Director and shareholder. The proprietor has substantial strategic experience in the UK Maritime and Industrial sectors, indeed it is perhaps worth noting that he was significantly involved in the UK defence industry consolidation process that resulted in the Commission's 1995 review of the proposed VSEL/BAe merger. He has also had dealings with DG Competition on the subject of a pan European level playing field for shipbuilding industry subsidies. Whilst clearly not an academic, the proprietor possesses a passionate interest in SME matters and has undertaken original post graduate pilot study research on behalf of the DTI, in the area of the causation of small firm failure. Thus, the proprietor would respectfully suggest that his potential interest is wider than that of a typical small firm entrepreneur, including perhaps, regulatory/social entrepreneurship and economic argument, commensurate with the choice of company name.

Although significantly resource constrained, Pareto have undertaken a fairly wide literature search as a preamble to this submission. Whilst persuaded of the excellence of Professor Paul Dobson's work, it is Pareto's initial observation that there appears to be a significant gap in academic understanding in the UK and Europe as to the critical economic nexus between small business vitality and antitrust – and that this should be a matter of national interest (C.f. the situation in the United States perhaps epitomized by argument presented by Allbert A Foer, President of the American Antitrust Institute in his paper 'Small Business and Antitrust: Why the little guys left the fold and why they should return.' Foer asserts: "The question addressed in this paper is how small business fits into a post-Chicago antitrust agenda. The answer, we will see, relates not to special privileges for the small, but to a vigorous competition policy directed against manifestations of market power."

Pareto are aware that in parallel with the CC Inquiry the American Antitrust Modernisation Committee (AMC) are considering, inter alia, the future regulatory relevance of the Robinson Patman Act. It is understood that although the AMC are likely to recommend that the Act is revoked, that Congress are unlikely to accede. Pareto recommends that the CC Inquiry compares the structure and regulation of the USA Grocery market with the situation in the UK. That the overall regulatory situation in the USA generally prevents the application of 'buyer/Market/seller power' by prohibiting price discrimination and providing for full transparency and efficient private litigation as a market correction mechanism (although it is argued that a tribunal based alternative dispute resolution system might be more appropriate in the UK). The end result is that the USA has the lowest consumer food prices in the world. That the regulatory regime has allowed Wal-Mart to grow to become the worlds largest company but still not entirely dominate in market share terms (currently thought to be ca 18%) and yet small retail entrepreneurship on the whole flourishes – and moreover tellingly, there has apparently been no need for a grocery sector inquiry.

Contrast this situation with the UK where price discrimination flourishes and the major supermarkets retailers allegedly can freely abuse their dominant positions, in breach of chapter 2 of the Competition Act 1998. Thus it is argued that in the UK the grocery market has failed and the 2006 CC Grocery Inquiry is urgently required to determine and effectively implement a series of suitable remedies (If one accepts the argument that the Supermarket Code of Practice has comprehensively failed to constrain the application of Buyer Power/Price Discrimination in the UK).

Pareto would conjecture in high level terms that there is an apparent lack of understanding that effective regulation is necessary within Europe (c.f. the USA situation) to facilitate the SME formation process. It being particularly argued that the SME formation process impacts both positively and centrally on the critical dimension of competition, which strategically considers the overall structure and process of competition in a market itself (i.e. making a fundamental contribution to maintaining a dynamic equilibrium between the forces of consolidation/monopoly and entrepreneurial start-up/perfect competition). Thus Pareto, would ideally like to see a clear connection between the CC Inquiry process into the UK grocery market and high level European economic strategy, such as the Lisbon Agenda (which is understood to be underpinned by Schumpeter's thinking on the paramount economic importance of the innovation process).

Indeed when one looks at DG Competition's recent Energy Sector Inquiry emerging issues work, one sees a certain symmetry of concern with the UK Grocery market issues. Viz:

- 1) Market concentration
- 2) Vertical foreclosure
- 3) Lack of European market integration.
- 4) Lack of transparency.
- 5) Price information problems.

Moving from the strategic to the operational level; It may assist the CC Inquiry process to consider what is argued to be a very clear and recent example of price discrimination against Pareto Retail Ltd by < > – for price discrimination can obviously equally apply to overhead items as to the cost of goods for resale (Indeed < > have been advised that as Pareto Retail are a main participant in the CC Inquiry and that their recent 150%+ price increase demand for handling cash deposits through a money process centre would be given to both the CC and OFT for consideration).

< >.

Equally, on a point of detail it may be that the Commission would appreciate clear evidence of the waterbed effect which is argued to go hand in hand with the application of market power. Might Pareto offer its own C-store experience with regard to this matter by way of example? When powerful suppliers such as < > set cost prices and recommended retail prices on < > that give small retailers little margin (often less than that on a packet of cigarettes at 6-8%) then the c-store operator who typically targets an overall margin of 20% to survive, has no option but to increase retail prices on items where the supplier has no market power.

Pareto are keen to ensure that our main submission letter remains as succinct as possible, and whilst we will append two earlier notes of potential relevance; we would invite the CC panel members to directly consider this local C-store investment development, which Pareto has observed over the years in ball-park detail terms:

There is ca 1,200 sq ft C-store unit on < >. In ca 1998 Pareto were offered this store by a major symbol group as it was trading problematically for them as a company managed store with a t/o of ca £10,000 per week. Pareto did not buy the store principally because of its high rental at ca £20,000 pa but it could see some potential as an owner managed store. Eventually, a Londis retailer took over the unit and refitted the store at great expense to the highest Londis standard (Genesis). Pareto would guesstimate that they increased the gross t/o

to ca £17,000 per week say £15,000 net of VAT, giving gross profits of ca £140,000 per year. In 2004/5 the shop came back on the market for ca £180,000. Pareto ran the opportunity through its financial screening model which suggested that a PBIT of ca £20,000-£30,000 could be achieved, after interest an uneconomic 5-10% ROI. In fact Tesco purchased the store last year and re-opened it as a 'One Stop' store. The standards are no better; the range if anything smaller and the prices probably on balance higher, hence sales performance is thought to be substantially unchanged. However, with Tesco's supermarket leveraged buyer power, their input cost of goods are conservatively 10% lower than the Londis store operator, yielding gross profits of ca £220k per annum and approx £100k PBIT on a like for like basis or a ROI of ca 50% at the store level.

Pareto believe the above example very clearly articulates why the Commission should be concerned about the impact of the unregulated phenomenon of buyer power and associated price discrimination, upon the process of competition in UK grocery retailing, particularly at the c-store level. It is Pareto Retail's view that Professor Dobson was correct to assert, in his 1998 research paper for the OFT 'The Welfare consequences of the exercise of buyer power,' that buyer power/market power/seller power could work in a vicious spiral to bestow ever increasing competitive advantage to retailers with market power. Of course the main difference now is that we are seeing the very clear anti-competitive impact of this phenomenon, working against the public interest. Pareto conclude by suggesting that in undertaking the 2006 Inquiry the CC should be particularly mindful to consider all the relevant risk/reward issues in detail and particularly the need to avoid further undermining the benefits of 'portfolio effect' diversity in a market of profound strategic importance. We question what lasting consumer benefit there is in allowing retailers with market power such as Tesco; Asda/Wal-Mart, Sainsbury, Morrisons and Aldi to build aggregate retail supply capacity equivalent to 100% of grocery market demand, effectively eliminating all nascent SME competition, and that this argument applies generally at the local, regional and national levels?

Finally, Pareto would repeat that we are delighted to have the opportunity to present to the above Commission Inquiry and indeed open our books as appropriate. We would note, however, that although 'Pareto Optimality' is classically regarded as a weak form of optimal efficiency, in our case we have a virtual head office arrangement save for the proprietor, and it is unlikely that we will be able to respond to information requests as readily as the norm with Inquiry participants. Similarly, that pressure of time and resources means that this submission is made in good faith, but without the benefit of external critique.

Yours faithfully

Adrian Costain
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Pareto Retail Ltd