

MICROMARKETING AND DISCRIMINATORY PRACTICES IN UK GROCERY RETAILING

Response to Professor Dobson's submission on behalf of the ACS

1. OVERVIEW

1.1 Professor Dobson's report "*Micro-marketing and discriminatory practices in UK grocery retailing*" ("the Report") was submitted to the CC in December 2006 on behalf of the ACS. It is a long report running to 84 pages and makes extensive references to the economic literature. This paper provides our detailed comments on the Report. In particular, we find the following.

- (a) The Report does not properly consider the *context* for the Groceries Inquiry. In some parts of the Report, there is an acceptance of the fact that competition in the grocery industry has increased and prices have fallen, yet the analysis of the various practices is carried out under a presumption that there are competition problems which enable retailers to exploit their customers. This is internally inconsistent and contradicts a wide range of other evidence – including that set out by the OFT in its reference to the CC – that competition has delivered substantial benefits to customers.
- (b) Moreover, the Report fails to recognise that retailers' marketing practices, many of which the Report considers to be harmful, in fact have *benign pro-competitive explanations*. All the practices provide goods and services that customers want – and denying these to customers (as the Report would appear to suggest) is likely to reduce consumer welfare rather than improve it. Moreover, many of these practices are common to all retailers, including retailers of non-grocery products.
- (c) A number of the *theoretical* arguments presented have no clear relevance to the practices which the Report describes. The Report's treatment of certain economic theories is often presented without a concrete discussion of how the theories apply to the UK groceries industry. This leads to an incorrect interpretation of the appropriate conditions for establishing consumer detriment.
- (d) The Report provides limited *evidence*. The evidence that is provided is either no longer relevant – as in the case of price-flexing – or is not given in support of any particular theory of harm to consumers.

1.2 Moreover, the discussion of possible remedies in the final Chapter does not directly relate to the competition problems discussed in the earlier sections of the Report, even if these had been established either in theory or in practice. We believe that any discussion of possible remedies is wholly unnecessary and is, in any event, inappropriate at this stage in the Inquiry.

1.3 The remainder of this paper is set out as follows. In Section 2 we investigate the context for the Report and consider the general approach taken towards the "*micro-marketing*" practices identified. In Section 3 we provide a description of the different practices discussed in the Report. These divide into three types:

- (a) in-store practices;
- (b) between-store practices; and
- (c) dynamic effects.

1.4 For each of these issues we provide a brief description of the specific practices considered by the Report, before drawing together and critiquing the points of theory and evidence made at various points during the Report (in particular Chapters 2-4). Some additional technical analysis is attached at Annex A.

2. THE CONTEXT

2.1 The Report appears to be aiming to paint a picture of an industry that engages in various marketing practices to extract money from a set of locked-in consumers. This picture is entirely incorrect: it is at odds with the views of a wide range of independent commentators and, we believe, would not reflect the views of customers. Nor is customer behaviour consistent with this view, given the high level of switching.

2.2 The Report fails properly to acknowledge clear matters of fact in the UK grocery industry. The Report does not properly consider the implication of the facts that there is a long-term trend of prices coming down, that range, quality and service are improving, and that customers are increasingly satisfied.

2.3 This omission is highly problematic for the Report's analysis. As we describe further in Section 3 below, the theories of harm outlined in the Report are predicated on a lack of competition in the grocery sector. Indeed, the Report assumes that there are high and increasing levels of concentration, together with a lack of effective competition, without any attempt to explore the substantial evidence of keen rivalry and competitive outcomes. Consequently, the Report's approach to micro-marketing practices is prejudiced. The Report also ignores the fact that the micro-marketing practices it identifies have clear pro-competitive pro-consumer interpretations. To take a few examples of practices criticised by the Report:

- (a) Providing price comparisons to customers provides customers with better information on the relevant offers of different supermarkets and so allows them to make a more informed choice of supermarket.
- (b) Providing parking spaces allows customers to drive to the supermarket which allows them to take home their weekly shopping – which for many customers is a great benefit as their full weekly shopping trip would be heavy and bulky.
- (c) Offering a range of trolley sizes allows – as the Report implicitly recognises – customers to choose a size of trolley that is appropriate for their desired level of spend.
- (d) Offering a range of quality and price combinations on products allows one store to satisfy the requirements of a variety of shoppers. Customers can choose the quality-price trade-off that they want – which could vary from product to product.

- (e) Placing similar items side by side in the store makes it easier for customers to navigate their way around the shop and allows them to choose more readily between the various products stocked to find the one that best meets their needs.

Yet each of these activities is painted in a negative light in the Report.

2.4 The Report does not recognise that many of these practices are common not only throughout the grocery sector but also throughout the retail sector as a whole. Convenience stores place similar items side by side, and offer a (smaller) range of quality and price combinations, as do many clothes retailers, sports retailers, DIY stores, or bookstores. Many retailers offer car parking facilities and a range of trolley sizes. The Report takes issue with practices that are carried out by virtually all retailers, regardless of sector.

2.5 It is further claimed in the Report that recent developments in the market have allowed retailers to carry out these practices to an increasing extent. The Report states that “*very detailed market information that retailers increasingly possess combined with possibilities to target individuals through database marketing are adding to the scope for such practices and increasing the ability of retailers to target ever more precisely their customised offers.*”¹ Yet the Report fails to recognise the contradiction between, on one hand, the supposed increase in the extent of these detrimental practices and, on the other, a period in which competition has intensified, prices have come down and customer satisfaction has increased. The Report misses the practical reality that it is retailers’ increasing knowledge about what their customers want that has driven them to adopt these practices, thereby contributing to the increase in competition. Were these practices to be removed, customer satisfaction levels would fall.

3. THE PRACTICES

3.1 In addition to the overall contextual weakness identified in Section 2 above, we consider the detail of the Report’s arguments and find that the treatment of ‘micro-marketing’ practices does not provide a robust theory, or any relevant evidence of how these practices could result in consumer detriment. The Report distinguishes between three sets of practices:

- (a) practices which result in different customers receiving different levels of price, quality and service within the same store (*in-store practices*);
- (b) practices which result in similar customers receiving different levels of price, quality and service across different stores (*between-store practices*); and
- (c) practices which, whilst potentially beneficial to competition in the short run, could result in a long run effect on competition in the market (*dynamic effects*).

3.2 Many of the in-store practices (such as selling different varieties of the same product) identified in the Report are common across many retailers. However, these are carried out for reasons entirely ignored by the Report – namely, that these meet

¹ The Report, page v.

the different needs of different customers. In contrast, we do not carry out between-store practices, such as price flexing, as envisaged by the Report. Our prices are the same across all our stores. Likewise, we do not engage in any of the practices underlying the dynamic effects concerns described in the Report to any material extent.

3.3 We discuss each of these practices below in further detail. In each case we draw out the points of theory and evidence upon which the Report relies, and where relevant address the conclusions which rest upon them.

(a). In-store practices

3.4 In-store practices relate to a variety of measures which the Report alleges retailers employ in order to charge different prices to different customers within the same store. The Report recognises that it is impossible to vary shelf-edge prices to discriminate between customers, but suggests that there are various other ways in which consumers may be segmented. Examples presented in the Report include:

- (a) providing plenty of parking spaces to encourage consumers to buy more than they would otherwise have carried by hand;
- (b) offering a range of trolley sizes to cater for different types of shopper;
- (c) offering a range of quality and price combinations;
- (d) offering products with non-standard shapes or unique quantities;
- (e) placing similar items side by side in the store;
- (f) offering “*reward card schemes and charity schemes (e.g. “computers for schools”)*”²;
- (g) operating a “*voluntary club-membership scheme ... (e.g. Baby & Toddler Club, Kids Club, and World of Wine)*.”³;
- (h) facilitating price comparisons with other stores;
- (i) informing customers of promotional offers by “*Express[ing] prices as discounts off the higher price usually charged*”⁴; and
- (j) offering “*multi-buy deals (e.g. “3 for 2”, “buy one get one free”, “buy one buy a second half price”) and cross-buy deals (e.g. “buy product x and get product y free/half price”)*.”⁵

3.5 The Report argues that by engaging in these in-store practices, retailers are able to soften competition and charge higher prices to some or all customers. The

² The Report, Table 1, page 13.

³ The Report, page 21.

⁴ The Report, Table 1, page 13.

⁵ The Report, page 14.

implication of this theory would be that if these practices were to be removed, retailers would be forced into more intense competition and prices overall would be lower.

3.6 We disagree that these practices could be expected to soften competition as a matter of theory. The Report also fails to provide any evidence that these practices do in fact soften competition. We discuss these points in detail below.

Theory and evidence

3.7 The Report does not present a single consistent theory for how in-store practices result in harm to customers. However, at various points the Report appears to put forward three distinct rationales for consumer detriment relating to in-store practices.

- (a) The practices serve to somehow reduce customers' price sensitivity.
- (b) The practices are designed to 'extract consumer surplus' thereby leaving customers worse off.
- (c) The practices allow customer segmentation which results in 'price-gouging', whereby all customers face higher prices.

We discuss each below.

No clear theory of reducing customers' price sensitivity

3.8 The Report argues that a number of in-store practices operate to reduce customers' price sensitivity. The implication is that the presence of these practices in the market means that customers are less likely to switch between stores in response to a price increase.

3.9 The Report does not explain by what means these practices are able to affect customers' willingness to switch to alternative retailers. For example, the Report alleges that placing similar items side by side reduces price sensitivity; or equivalently, that customers are more likely to switch between two retailers who do not place similar items side by side than they are to switch between two retailers who do place similar items side by side. The Report does not explain how this could be the case. It seems counter-intuitive that customer switching would be greater between stores where the relative prices of similar items were less transparent.

3.10 The Report consistently confuses practices which are *elements of* competition with practices which might *affect* competition. For example, the Report suggests that in order to "*encourage more purchases by different types of shopper, bigger/deeper trolleys...have become prominent over recent years to cater for the large weekly shopping trip while baskets have been supplemented with shallow/easy-to-manoeuvre trolleys*".⁶ In reality, rather than *causing* customers to purchase different amounts, the introduction of different sized trolleys is a *response* to the fact that customers purchase different amounts.

⁶ The Report, page 11.

3.11 The flawed logic of the position set out in the Report is clearly demonstrated by considering the reverse position. Would competition be fiercer or customers be better served if stores offered only one size of shopping trolley? Or if stores deliberately put similar items in different parts of the store? Or if stores made price comparisons with other stores more difficult? We do not believe any of these could be true.

3.12 In Table 1 below we consider each of the practices cited by the Report. In each case, we find that the practice would either have no effect on, or would likely serve to increase, customers' price sensitivity.

Practices which the Report claims “reduce price sensitivity”

“Place similar items side by side”

It seems counter-intuitive that locating similar items in different parts of the store could *increase* customers' price awareness – facilitating price comparisons is likely to make customers more price sensitive.

“Keep prices broadly consistent over time (as in an EDLP approach)”

The objective of an EDLP approach is to make customers aware of lower prices and so to make them more likely to switch away from higher priced competitors. Keeping prices consistent over time is likely, if anything, to enhance this awareness and will increase rather than decrease, customers' price sensitivity.

“Use packs with non-standard shapes or unique quantities”

The variety of pack sizes is intended to satisfy the needs of a broader range of customers. Since all stores are capable of offering this variety, there is no reason why this would reduce customers' willingness to switch between stores. Our price policy is designed to ensure that prices on different pack sizes are competitive *per quantity* offered, so there is no scope for Tesco to engage in this practice. We provide information on the price per kilo for the different pack sizes of all relevant products (or price per unit where appropriate) so that customers are fully informed about the relative value for money of each option. Indeed, this is a legal requirement.

“Use reward card schemes and charity schemes (e.g. “computers for schools”)”

Reward card and charity schemes are an element of competition between retailers and not a substitute for it. Since these schemes are available to all retailers, there is no reason why this would inhibit price competition between retailers, or reduce customers' willingness to switch between stores.

“Create distinct store layouts and retail brand image”

Customers appreciate knowing the layout of the store and get frustrated if too many changes are made to store layouts. The practice of keeping a consistent layout and brand image reflect a desire to make the shopping experience as easy as possible for customers, enabling them to know what they are buying and where it can be obtained. For example, customers tell us they want to shop for non-food lines before they reach the chilled and frozen produce, so non-food lines are typically located at the front of a store.

“Use price comparisons with other stores”

The provision of price comparisons reduces the costs to the individual of obtaining information on the available alternatives – thereby making it easier for customers to switch. As stated above, making customers aware of lower prices has the objective of making them more responsive to price differences between competitors.

“For goods like wine, use clear price steps as a means of communicating increasing benefits through the range to counter price sensitivity”

Providing wines at different price points allows customers to choose their preferred price/quality combination. Different prices on these products reflects the cost of provide different levels of quality. The Report offers no alternative pricing structure for similar products of different qualities which it believes would be more competitive.

“Price small, one-off purchases (e.g. a snack for immediate consumption), bought spontaneously and without close scrutiny, relatively high, but the core constituents of the weekly shop relatively low”

“Operate with keen prices on basic/core items in the weekly shop and then higher margins on additional “treats” (e.g. confectionery for indulgence)”

“Set higher margins on “fair trade”, “organic” or “locally produced” goods”

Tesco does not systematically aim to operate higher margins on any of these groups of products. For example, in the last financial year [1].

Product margins can vary between products for a large number of reasons. In every category, there are more products available than can be accommodated on the shelves in our stores, creating competition for every inch of shelf space. Because we offer the widest possible range of products to our customers it may be that some products will be more costly to stock and only commercially viable at higher margins.

There is no reason why offering this breadth of choice would affect customers' price sensitivity. Indeed, in a world where all stores offered only the same high volume, low margin products it likely that customers would have less incentive to shop around, rather than more.

“Express prices as discounts off the higher price usually charged (as with Hi-Lo promotional pricing)”

Where possible, Tesco promotions are expressed in terms of the monetary saving to customers (for example, “save £1”). However, promotions are sometimes given in terms of a discount off the higher price simply because the offer cannot be expressed as a monetary saving (as with an offer on a range of products, such as ‘20% off all clothing’). It is not clear that this form of labelling rather than another would have any effect on customers' price sensitivity.

Moreover, since Hi-Lo pricing is the opposite of EDLP pricing, the Report appears to be arguing that any type of pricing strategy reduces customer sensitivity (and it is not clear what alternative price strategy is available which the Report would find less problematic).

Table 1: The alleged “micro-marketing” practices and their actual effects on price sensitivity

Captured consumer surplus would be returned to customers

3.13 The Report argues that ‘micro-marketing’ strategies are designed to exploit each customer’s individual willingness to pay and “*extract as much consumer surplus as possible*”.⁷ As we have made clear above, these practices are not carried out with the objective of exploiting customers’ willingness to pay.

3.14 However, even if such strategies did allow greater surplus to be extracted, the ability of retailers to extract this surplus from customers relies on customers entering the store in the first place. The Report, to a certain extent, acknowledges this: “*the retailer will wish to make the shopping experience pleasant (or at least not off-putting) to encourage regular repeated custom, and cater for a wide set of (if not all) shoppers’ needs to build store loyalty and deter them from shopping elsewhere.*”⁸

3.15 To the extent that retailers benefit from improvements in their offer – for example, if offering new products encourages customers to spend more within the store – surplus created for the retailer through micro-marketing would be competed away in the form of inducements to choose that store. Because every retailer is simultaneously seeking to improve existing customers’ options in-store and to win new customers away from other stores, the ‘surplus’ from an improved offer would be invested in winning new customers by lowering average prices. As we have made clear previously, this is a mechanism for customer benefits which the Report entirely eschews.

3.16 Furthermore, whilst the Report would suggest that, if anything, these in-store practices have increased in recent years, it accepts the OFT’s evidence that increased competition amongst retailers has led to lower prices overall. There is no evidence to suggest that these practices have led to an increase in retailers’ profitability. If anything, the evidence in the CC’s Emerging Thinking shows that industry profitability has fallen. This evidence is entirely consistent with the theory that competition forces any captured consumer surplus to be returned to consumers in the form of lower average prices and improvements to range, quality and service. It is entirely inconsistent with the theory of harm set out in the Report.

‘Price-gouging’ relies on assumptions which are economically counter-intuitive

3.17 In proposing the phenomenon of ‘price-gouging’, the Report relies on the economic theory behind a particular type of price discrimination. We do not accept that the practices the Report describes operate as a mechanism for price discrimination between customers, either in theory or in practice. Notwithstanding this point, we find that the Report’s application of price discrimination theory is misleading.

3.18 Although there are a number of possible interpretations of the theories of price discrimination on which the Report relies, these theories are typically applied to discrimination by location. When customers are differentiated by location, customers close to one store will be far away from another. If customers incur greater costs by travelling further, then – all other things being equal – customers will have a

⁷ The Report, page 8.

⁸ The Report, page 10.

preference for their closest store.⁹ This results in firms having what the Report describes as “*opposite views on strong vs. weak markets*”¹⁰ – because the customers which have the strongest preference for travelling to one store will have the weakest preference for travelling to another.

3.19 As we have stated above, this cannot be a theory which applies to micro-marketing practices. It would have to be the case that customers’ desires to purchase different in-store offers were correlated with their relative closeness to that store compared to other grocery stores in the area. For example, customers living close to or far from a store would have to systematically choose smaller or larger trolleys.

3.20 However, the Report simply assumes that grocery retailers can exercise this form of price discrimination and then argues that prices with discrimination may be higher on average than without discrimination. It states:

*“If, in contrast, the competitive focus is on retaining loyal customers through discriminatory inducements rather than aggressively targeting marginal consumers or trying to poach the rivals’ loyal customers, then average prices may be higher than in the absence of discrimination.”*¹¹

3.21 We entirely disagree with this representation of the underlying economic theory.

3.22 We have reviewed the theoretical literature on which the Report bases its claim and find that its conclusions from that rely both on unrealistic assumptions and on firms’ irrational behaviour. In particular, for the theory to work it would have to be the case that retailers choose to locate their stores away from their most valuable customers, and close to their least valuable customers – which is plainly counter-intuitive.

3.23 Understandably, the Report does not provide any evidence to demonstrate that this is happening and it would be remarkable if any such evidence could be found.

3.24 We present the technical details of our findings in relation to the economics of location-based price discrimination at **Annex A**.

(b). Between-store practices

3.25 We contest the entire basis of the Report’s claims that retailers use between-store practices to compete differently in a series of distinct local markets. Competition in the UK grocery market takes place at the national level, and therefore the application of a theory predicated on a series of distinct local markets is misconceived. Nonetheless, *taking the assumption of distinct local markets at face value*, this section considers the Report’s findings in relation to between-store practices.

⁹ This logic is similar to the approach we have taken in applying the geographic SSNIP test.

¹⁰ The Report, page 44.

¹¹ *Ibid.*

3.26 Between-store practices relate to a variety of measures that the Report alleges retailers employ in order to charge different prices to similar customers in different stores. The prime example cited in the Report is “price flexing”, but the Report lists a host of marketing variables in addition to price that could potentially be varied to reflect different market conditions in different areas, including local advertising, promotions, coupons, product range, category depth, store layout, customer amenities, sales service levels, opening hours, store ambience, even format and store location.

3.27 Micro-marketing between stores is used, in the Report’s view, not only to maximise the retailer’s sales revenue by exploiting consumers’ varying willingness to pay in different locations, but also to compete in an aggressive way in selected locations “*to eliminate or at least undermine the competition.*”¹²

3.28 We disagree with the Report. The theoretical argument that is presented has ambiguous consequences for consumer welfare. But more importantly, the evidence is entirely contrary to the allegations made in the Report. There is no price flexing, as is reluctantly acknowledged in the Report, and there is no material evidence for any other form of PQRS flexing.

Theory and evidence

3.29 The Report presents the following argument in relation to between-store practices:

- (a) Retailers – now or in the foreseeable future – are likely to flex prices, or some non-price element of their offer, in response to local competitive conditions.
- (b) The welfare effects of such flexing are ambiguous – these practices leave some customers better off, and some customers worse off – but that circumstances in the UK grocery market are such that flexing is likely to be harmful overall to customers.

3.30 We consider each of these points in turn below.

Price flexing is no longer relevant

3.31 A large proportion of the evidence in relation to between-store practices contained in the Report is taken from the findings in CC’s 2000 Inquiry in relation to price flexing. This evidence is no longer relevant to the UK grocery market. As the Report (reluctantly) acknowledges “*While price flexing has continued to be used by some of the smaller chains, by 2004 all the major one-stop-shop chains had ostensibly adopted a policy of setting national prices across their supermarkets. By 2003, both Sainsbury and Tesco had voluntarily moved away from store pricing based on location.*”¹³ We take issue with the word “ostensibly”. Our national prices are available for anyone to see on our online price checker.

3.32 Given the evidence that price-flexing is no longer a feature of competition in the UK grocery market, the Report goes on to suggest that there is a prospect of a

¹² The Report, page 23.

¹³ The Report, page 35.

move towards re-introducing price-flexing. This suggestion is speculation, and runs counter to the trend towards greater competition at the national level. The allegation that “*the price flexing practice may return once these retailers are no longer on the acquisition trail and the regulatory spotlight is off*”¹⁴, ignores the straightforward fact that all the largest UK grocers have chosen to abandon price-flexing because national pricing is a more competitive strategy.

3.33 In respect of non-price flexing, the Report suggests a long list of factors which could vary with the extent of local competition, but presents no evidence to suggest that such variations actually exist.

3.34 We have made plain in our evidence to the CC that there are no material differences in Tesco’s retail offer between areas. We operate in a national market, and have a national price list, national service standards, and a national brand supported by national advertising. Range, prices, staffing, numbers of in-store facilities, queuing times, opening hours, customer service, stock availability and time since refurbishment are key parameters of competition that are determined centrally with centralised monitoring processes which limit the ability to vary the offer between stores. In our evidence relating to *Local concentration and PQRS* we have conclusively demonstrated that there is no relationship between any aspect of our retail offer and local market structure, however a local market might be defined.

Flexing has ambiguous welfare effects

3.35 The Report proposes that consumer detriment arises if, on average across different locations, customers were to face a worse offer (e.g. higher prices) than would be the case with a commitment to national prices and policies. The Report correctly acknowledges that the outcome of local flexing would have ambiguous effects for customers.

3.36 In the presence of significant local variations, moving from a uniform to a localised offer would make some customers better off, whilst making other customers worse off. This follows logically from the fact a uniform offer would take the form of an ‘average’ offer, somewhere between the most competitive and least competitive local equivalents.

3.37 The Report further sets out conditions under which it argues local flexing would be likely to be harmful overall:

*“the significant presence of local monopoly and local duopoly situations in conjunction with substantially more competitive local markets... is thus likely to give rise to a situation where price flexing overall harms consumers by raising average prices compared to when retailers nationally price.”*¹⁵

3.38 The Report does not provide any theory as to why the circumstances described would lead to higher average prices, or any evidence that the circumstances for damaging price flexing exist in the UK grocery market.

¹⁴ The Report, page 37.

¹⁵ The Report, page 46.

3.39 Nonetheless, the Report appears to require that, for flexing to be harmful overall, the benefits to retailers (in the form of higher prices) are limited to a small number of markets. The Report fails to recognise that, when there are some benefits to a uniform offer, or some costs associated with localised offers, retailers are unlikely to find it profitable to use locally determined offers in order to obtain higher profits in only a small number of locations. As we have presented in our evidence to the CC, there are considerable advantages to national branding and national strategies. The Report implicitly accepts that national factors act as a genuine constraint when it states “*As will become evident, the secret to the success of these practices will be in making consumers believe that they are obtaining the best value for their own circumstances. If consumers learn or believe otherwise then there may be a “consumer backlash” against the retailer.*”¹⁶ It is clear that there is extensive media and non governmental organisation scrutiny of supermarkets. As a result localised offers would be quickly spotted and a ‘consumer backlash’ would almost certainly result.

(c) Dynamic effects

3.40 As well as any immediate effects on consumer welfare, the Report considers possible long-term effects based on what it calls the operation of “market dynamics”.¹⁷ The Report considers three possible effects:

- (a) collusion;
- (b) predation, particularly through price flexing and below-cost selling; and
- (c) exploiting customer loyalty.

3.41 Below we consider the theory and evidence in relation to each of these practices. To summarise, the Report dismisses the first effect. In relation to the second and third effects, the theories offered in the Report are entirely speculative and the Report provides no evidence for either.

Theory and evidence

Collusion

3.42 The Report considers, but ultimately dismisses, a theory that the move to uniform pricing might have the detrimental effect of facilitating collusion between retailers.¹⁸ Tesco agrees with the Report that this possibility does not represent a convincing theory, and with the CC that there is no evidence of tacit coordination taking place in the sector.¹⁹

¹⁶ The Report, page 9.

¹⁷ The Report, page 49.

¹⁸ The Report, page 50.

¹⁹ CC, *Working Paper on Coordination*.

3.43 We further agree that the market has in fact moved towards more intense competition at the national level, and that this has led to lower prices for all customers.²⁰

3.44 It is not clear why this finding in the Report is not given greater prominence. This observation is entirely inconsistent with all the material on detrimental effects of price discrimination, and the dynamic effects described in this Section. We believe that the appropriate conclusion to be drawn about the competitiveness of the grocery sector is one of intense and growing competition.

Predatory price flexing and below-cost selling

3.45 The Report argues that there is a potential detrimental impact of price discrimination on the structure of the market, where price discrimination is combined with predatory local behaviour. It states, “*the combination of local price flexing with targeted below-cost selling could form a powerful discriminatory cocktail focused on undermining local or specialist retailers.*”²¹

3.46 The Report does not provide a convincing theoretical case as to why these practices should lead to the detrimental effects claimed (and provides no evidence that these effects are occurring – an observation to which we return below). To establish a theoretical justification for the practices of predatory below-cost selling and price flexing to be harmful, it would be necessary (at least) to demonstrate the following:

- (a) a firm was able to exploit a source of market power;
- (b) the practice is below cost;
- (c) the practice is capable of eliminating competitors; and
- (d) recoupment is possible after the predatory activities have occurred, such that the elimination of these competitors is sufficient to make the predatory activity profitable overall.

3.47 The Report suggests that this predatory process would be a “*slow, drawn out affair rather than a quick exit*”, primarily directed at “*small or specialist retailers*”²². This is unconvincing. If predation were occurring – which is costly because prices would be below cost – the predator would have the incentive to eliminate competitors as quickly as possible. It is also unclear, if the outcome were a gradual exit of smaller retailers, how this could be identified as being the result of predatory below cost selling, rather than a variety of other factors such as, for example, greater efficiency and lower (above cost) prices of larger retailers, a greater shift to the use of large supermarkets as a response to car ownership, or cost increases in small stores as a result of minimum wage increases or higher energy and rent prices.

3.48 The Report only considers persistent below cost selling to be a problem. But the CC recognised in its Emerging Thinking that long-term predation provides no

²⁰ The Report, page 50.

²¹ The Report, page 51.

²² *Ibid.*

opportunities for recoupment. Moreover, the Report does not present any evidence on the extent of below-cost selling, or that it is sufficient to have a material impact upon any grocery retailers, including small and specialist retailers. The evidence Tesco has submitted to the CC has shown that below-cost selling would have a minimal impact on smaller retailers, for whom the price difference to the large national retailers is several orders of magnitude above the impact of below-cost selling on the price of an average basket.

3.49 The Report argues that a predatory strategy might be profitable as price-flexing could limit the profit loss associated with predatory activity to areas where a retailer competes against candidates for predation. We have shown above that price flexing above cost cannot be considered predatory. But even taken at face value, predating in a small number of areas would limit the benefits as well as the costs, since there would be only a few areas in which recoupment could take place. There is no clear reason why this observation would be more likely to make a predatory strategy profitable.

3.50 Secondly, the report states that predation is more likely to be a successful strategy if – once a competitor has been eliminated – there are barriers to entry which enable retailers to increase prices without attracting fresh entry and more competition. But the Report fails to address the issue of how or why such barriers to entry might exist. The OFT has previously found that barriers to entry in the convenience sector are low.²³ Given that there is no evidence that barriers to entry exist, the presumption must be that a predatory strategy would not be profitable.

3.51 As we have stated above, the evidence presented by the Report in respect of price flexing is no longer relevant to UK grocery market and there is no evidence of other forms of non-price variation in response to competitive conditions.

Exploiting consumer loyalty

3.52 Having considered detriments that would be the result of prices being too low, the Report then considers detriments that would arise from prices being too high. The Report explores a hypothesis whereby building consumer loyalty may succeed in ‘locking’ consumers into particular retailers in a way which “*may eventually allow the retailer to set higher prices*”²⁴ and hence be damaging to consumer welfare.

3.53 The Report recognises that – were this to be a credible practice – customers would benefit in the short run from a situation where retailers competed intensively to win customers’ business upfront, before facing higher prices in the future when they are ‘locked in’. But as we have described above, there are no reasons to believe that customers are locked in by any of the practices described, nor are there any reasons why rival retailers could not reproduce these practices. Both observations mean that this theory cannot hold. Even if this theory did hold, its welfare consequences would be ambiguous, since customers would gain from lower prices now, while losing as a result of high prices in the future.

²³ OFT, report into the merger of Tesco/T&S.

²⁴ The Report, page 54.

3.54 The Report postulates a point in time where “*competition can be expected to subside, even evaporate entirely*”²⁵ as result of customers becoming locked in. This is completely speculative and without theoretical or empirical justification. It is not clear from the Report what, in the UK grocery industry, is likely to trigger a situation whereby retailers decide to stop competing for new customers and instead exploit existing customers. The market is so competitive that such a situation strikes us as inconceivable. Even if a retailer were to reach such a decision, the Report is equally silent on what factors would prevent customers from deciding to shop elsewhere.

3.55 In order to provide any support this theory, it would be necessary at least to show customers becoming less inclined to switch between retailers. No such evidence is presented in the Report. Tesco’s evidence to the CC has shown that, on the contrary, the extent of customer switching has increased.

²⁵ The Report, page 54.

ANNEX A

Economic analysis of location-based price discrimination models

Chapter 4 of the Report contains a discussion of “*Opposite Views on Strong vs. Weak Markets*”,²⁶ focusing on the circumstances in which price discrimination between customers at the level of an individual store is likely to result in customers facing higher prices overall. This theory is not empirically relevant given the fact that all major firms price nationally, as found in the CC’s Emerging Thinking. But even if it were, we find that the theory on which this discussion relies would in fact support the *opposite* conclusion – stores would be expected to compete on a number of dimensions and drive prices down to all customers.

The Report employs the economic theory of location-based price discrimination

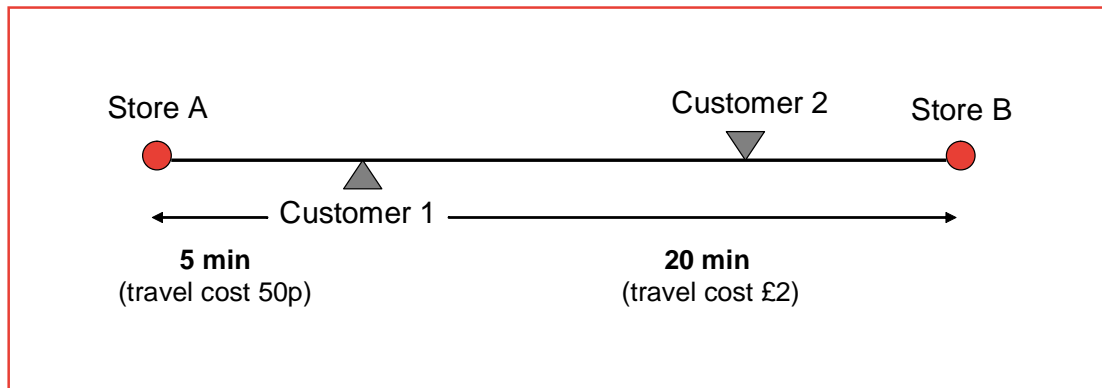
This discussion relies on the economic theory behind a particular type of price discrimination which does not occur in the supermarket sector because supermarket retailers do not price discriminate between customers according to their willingness to switch between stores (as shown, for example, by the fact that all major supermarket operators have national prices). Nevertheless, we will proceed taking the Report’s assumption that such price discrimination is possible at face value and demonstrate that the conclusions reached from this assumption are incorrect.

As a stylised example, consider a situation where customers are differentiated by location, so that customers close to one store will be far away from another. If customers incur greater costs by travelling further, then – all other things being equal – customers will have a preference for their closest store.²⁷ The “*opposite views on strong vs. weak markets*” arise because the customers which have the strongest preference for travelling to one store will have the weakest preference for travelling to another. This illustrated by the diagram below. Other things being equal, Customer 1 will pay an extra £1.50 to shop at Store A rather than incur the cost of travelling a further 15 minutes to Store B. In this sense Customer 1 and other nearby customers represent Store A’s ‘*strong market*’. In contrast, Customer 2 find shopping at Store A an extra £1.50 more expensive – putting Customer 2 into Store A’s so-called ‘*weak market*’. From the perspective of Store B the situation is reversed – Customer 2 is in the ‘*strong market*’ and Customer 1 is in the ‘*weak market*’. This is what the Report refers to as “*opposite views on strong vs. weak markets*”.²⁸

²⁶ The Report, see Section 4.2.1.

²⁷ This logic is similar to the approach we have taken in applying the geographic SSNIP test.

²⁸ The Report also refers to this using the term “best-response asymmetry”. This is a term taken from the price discrimination literature which refers to situation where, under price discrimination, otherwise symmetric firms will respond differently to the same price being set by their rival – due to the difference in relative travel times.



Whilst differentiation by customer locations is the standard application of this theory, in principle this model can be used to think about any kind of differentiation between firms – not just geography – which makes customers more or less inclined to shop at a particular store.

It is not clear that this type of price discrimination exists

As we have outlined above, the wide range of so-called “micro-marketing” practices which the Report describes do not discriminate between different customers. None of the aspects of our offer are denied to any group or groups of customers and improvements in our offer are designed to benefit all customers. Each one of the practices the Report describes has a common-sense justification – that is, giving customers what they want. Tesco is a broad church, and so the variety in our offer reflects the variety in our customers’ expectations.

The report provides no discussion of how the practices described in Chapter 2 could be employed to charge different prices depending on a customer’s willingness to switch to a rival – for example by setting different prices to customers depending on their location. Offering Value products to price-sensitive customers and Finest products to quality-sensitive customers increases the overall attractiveness of a store to its customers; it is not clear at all that the size of these benefits would be related in any way to how close a customer lived to a rival’s store. The Report confuses practices which are *part of competition* for practices which would *affect competition*.

The theory of consumer harm relies on higher prices

Assuming for the sake of argument that grocery retailers could exercise the necessary form and level of price discrimination, it is the Report’s view that prices with discrimination will be higher on average than without discrimination. The Report argues that this will occur whenever stores offer lower prices to ‘loyal’ customers and higher prices to ‘marginal’ customers. It states:

“If, in contrast, the competitive focus is on retaining loyal customers through discriminatory inducements rather than aggressively targeting marginal consumers or trying to poach the rivals’ loyal customers, then average prices may be higher than in the absence of discrimination.”²⁹

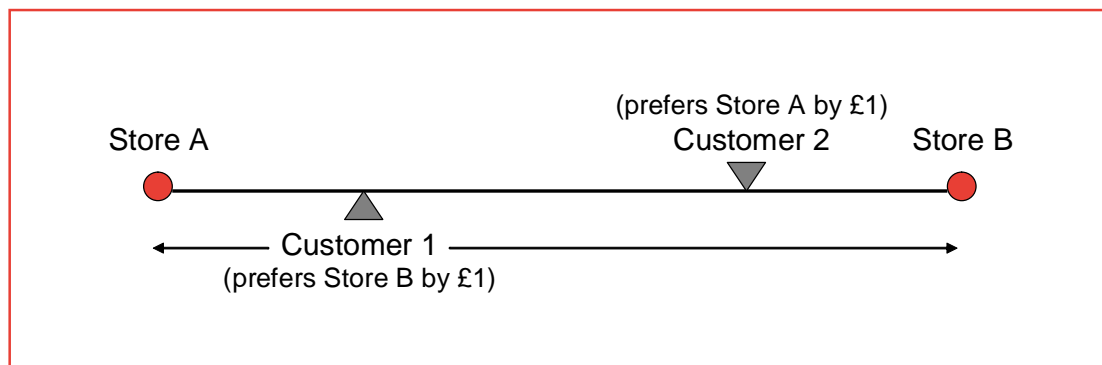
²⁹ The Report, page 44.

We entirely disagree with this representation of the underlying economic theory. To support this statement, the report refers to a result in the theoretical literature referred to as ‘price gouging’. As we made clear in our response to the *Emerging Thinking Pricing Practices Working Paper* such ‘price gouging’ results are economically counter-intuitive and exist as mathematical possibilities in models which as standard predict intense competition. The Report’s representation of the circumstances under which ‘price gouging’ results would apply is wholly misleading.

The Report states that higher prices would be expected whenever “the competitive focus is on retaining loyal customers through discriminatory inducements rather than aggressively targeting marginal consumers”. Yet in models of this kind – regardless of the assumptions made – price discrimination always involves targeting marginal consumers. As shown by the example above, a firm will cut prices more aggressively to customers who are further away – to counteract the fact that they must incur higher travel costs.

To obtain a ‘price-gouging’ result, one must assume that marginal customers are particularly valuable – they favour one store much more than other. So taking the location example, customers are required to favour the store which they are furthest away from. To see why this increases prices under discrimination, consider again the simple example from above.

- (a) **No price discrimination.** Both stores offer the same price to Customer 1 and Customer 2. If Customer 2 is very valuable to Store A then A will set a low price to both customers in order to win over Customer 2. And, because Customer 1 is most valuable to Store B, B will set a yet lower price to attract Customer 1 to travel the extra distance. The result is an extremely competitive uniform price.



Suppose both firms are setting a price of £5. Customer 2 will pay an extra £1 for the products at Store A compared to Store B, although he is further away from Store A and closer to Store B. The reverse is true of Customer 1. Because the extra cost of travelling to the further store is £1.50 for both customers, it is still true that – at equal prices – both customers shop at their nearest (and least preferred) store. Under these assumptions, Store A can attract Customer 2 by dropping uniform prices by only 50p – sacrificing less profit on Customer 1. This will be a profitable move as long as Store A’s costs are below £4.

- (b) **Price discrimination.** The stores can now set different prices to the two customers. Because the uniform price was set primarily by a desire to attract Customer 2, Store A can increase prices to Customer 1 without losing business to Store B. Similarly, Store B can increase prices to Customer 2. This allows all prices to drift up.

Suppose both firms are setting a uniform price of £2.50. Store A can increase the price to Customer 1 by up to 50p before it is worthwhile for Customer 1 to switch to Store B (the additional £1.50 travel cost, less the additional £1 benefit from shopping at B).

Store A can consider lowering its price to capture the Customer 2. To attract Customer 2, Store A would have to lower its price from £2.50 to £2 – since Customer 2 has to be compensated for an extra £1.50 travel cost, but prefers A’s product by £1. If Store A has costs above £2, this will not be a profitable price cut.

The assumption that marginal customers have higher valuations (and conversely that non-marginal customers have lower valuations) for a particular store has two possible interpretations. Neither of these makes economic sense.

- (i) **Retailers are differentiated by their location.** In this interpretation, as above, ‘marginal’ customers are those who are close to a rival’s store. As discussed in our response to the *Emerging Thinking Pricing Practices Working Paper*, assuming that these marginal customers have higher valuations requires customers who prefer one type of store to be systematically located close to a different type of store. The equivalent of assuming that a high-quality high-price firm would choose to locate in a less affluent area, whereas a low-quality low-price firm would choose to locate in a more affluent area.
- (ii) **Retailers are differentiated by offer.** An alternative interpretation would be if stores were differentiated by offer, rather than location, such as if one store provided a high-quality high-price offer, whereas another store provided a low-price low-quality offer. Under this interpretation a store’s ‘marginal’ customers are those who have a strong preference for the rival’s offer. Now assume that stores can – using “*micro-marketing*” practices – price discriminate between customers based on their income. To obtain the ‘price-gouging’ result, a store’s marginal customers must also be its most high value customers – the equivalent of assuming that a high-quality high-price stores would find low income customers the most valuable to capture.

In both cases, the Report’s description of the theory as requiring that “*the competitive focus is on retaining loyal customers through discriminatory inducements rather than aggressively targeting marginal consumers*” is wholly inappropriate. In reality, using economic theory to demonstrate that UK grocery prices have increased as a result of in-store discrimination not only goes against the facts, but would require economically counter-intuitive assumptions about customer behaviour.