

# SUPERMARKETS' IMPACT ON CONVENIENCE RETAILERS<sup>1</sup> AND THE HIGH STREET (15 DECEMBER 2006)

## 1. EXECUTIVE SUMMARY

1.1 It has been put to us that supermarkets are responsible for driving independent convenience retailers out of business and – either separately or as a consequence of this – have damaged the High Street by contributing to a lessening of diversity. This paper examines these assertions and demonstrates why they are ill-founded. The comments made are without prejudice to our view that there is a single national market for grocery retailing in the UK, regardless of store size.

1.2 It is necessary first to put these assertions in context. Supermarkets have brought tremendous benefits to consumers, as the OFT acknowledged in its Reference Decision. The relatively recent entry by supermarkets has extended these benefits to the convenience end of the market and, as recognised by independent commentators, has resulted in other players raising their game in order to compete.

1.3 Verdict has stated that, “*The impact of Sainsbury’s and Tesco’s increasing pressure has raised competition and retail standards. The multiple retailers have brought fresher food, new ranges, lower prices, better store environments and increased scale to the neighbourhood and it has forced smaller players to improve to keep up*”<sup>2</sup>. The IGD concluded in 2005 that, “*the c-store sector is now more competitive than ever*”. Customers are responding to the increased rivalry – and the better quality products and lower prices that it has brought – and turnover for the sector is expected by the IGD to reach £30.7 billion by 2011, representing growth of some 23% on 2006 turnover of £24.9 billion.<sup>3</sup>

1.4 Nonetheless, questions have been raised whether this success has come at undue cost. Has supermarket behaviour led to the decline of independent convenience retailers and, if so, does this amount to an adverse effect on competition? This question is explored in detail below, and we conclude that while there have been a number of changes in the makeup of UK grocery retailing in the past 50 years – changes which have included the exit of inefficient operators – consumers have overwhelmingly benefited.

### **Decline in convenience operators**

1.5 There has been a long-term decline in the number of independent convenience operators, but the evidence indicates that the rate of decline has slowed in recent years (which, coming at a time when supermarkets are growing, seems in and of itself to undermine the submissions made); that swathes of the sector are doing better than they have ever done before; and that – to the extent that there is any causal link between the entry of supermarkets into the convenience sector and the decline of independent players – it would be because customers prefer supermarkets’ offering.

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<sup>1</sup> For the purposes of this paper we have used the Institute of Grocery Retailing (*IGD*) definition of convenience stores: stores which have a dedicated convenience format, are less than 3,000 sq.ft. in size, and which stock a range of products from at least 8 core categories.

<sup>2</sup> See *Neighbourhood Retailing 2006*, Verdict.

<sup>3</sup> IGD, *Convenience Retailing 2006*, pages 4-7.

Supermarkets have been better at generating efficiencies, keeping costs down for customers, and responding to the changes – further described in paragraphs 2.22 to 2.28 below – in technology, society and consumer preferences. In short, our entry has been pro-competitive.

1.6 Against such a backdrop, specific hypotheses that have been levied against supermarkets to explain how they are supposedly driving other operators out of business through anticompetitive practices are entirely implausible. The feasibility of the “tipping point” and “waterbed” theories are undermined by an absence of any evidence to support them. Accusations of price flexing, below cost selling and targeted promotions suffer from errors of fact.

(a) *Tipping point* – The theoretical underpinnings of the tipping point theory are highly unreliable and the theory is not sustainable in practice. As described above, convenience operators are on the whole trading well. So too are grocery wholesalers, whose turnover is steadily rising. Some are currently doing very well. Palmer & Harvey McLane Limited (**P&H**), for example, has stated that “*P&H has seen massive growth in sales, sustained in the majority by a move from the niche market supply of confectionery and tobacco to a full, comprehensive range of up to 9,000 lines spanning ambient, chilled & frozen and alcohol sectors*”,<sup>4</sup> and that “*we anticipate continued growth at 4% despite tough conditions*”.<sup>5</sup>

. In other words, any impact on the wholesale sector by supermarkets in general, and particularly by Tesco, has been minimal.

(b) *Waterbed* – As with tipping point, it is very difficult against the backdrop of a successful convenience sector to envisage the waterbed effect taking place in practice. For example, 65% of convenience store retailers agreed last year that “*my company is in a stronger position than [the previous] year when negotiating with suppliers*”, with only 10% disagreeing<sup>6</sup>.

We establish in this paper that the model of the waterbed effect is flawed, as the assumptions that it uses are unrealistic. And we have seen no evidence other than theory that suggests that the waterbed theory is credible.

(c) *Targeted promotions* – We do not target promotions against competitors in order to cause them to exit the market. The purpose of our short-term (generally, four-week) promotions is simply to encourage customers to visit our new, refitted or under-performing stores. Whether they then choose to return and shop with us depends entirely on the quality of the offer that they find once they have chosen to come through our door for the first time.

We have seen no evidence of any market exit as a result of these promotions, and nor, for the reasons described above, would we expect to do so.

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<sup>4</sup> [www.palmerharvey.co.uk/ph-about.asp](http://www.palmerharvey.co.uk/ph-about.asp).

<sup>5</sup> Palmer & Harvey Managing Director, Graham McPherson, quoted in *The Grocer*, 28<sup>th</sup> January 2006.

<sup>6</sup> IGD, *Convenience Retailing 2005*, page 91.

- (d) *Price flexing* – We price nationally. Although Express and a small number of our Metro stores are on a different national list to the rest of the business, this reflects the greater cost in running these stores which are smaller or in high-rent locations. We do not price flex within any format.
- (e) *Below cost selling* – While we do not have a policy of selling below cost, we are occasionally driven to do so in response to the intense competitive rivalry of the retail market. As we show below an analysis of the effect of below cost selling on a typical Express convenience store suggests that any effects on smaller retailers are likely to be limited.

1.7 In other words, it is not feasible to claim that behaviour (other than that in the sense of normal commercial rivalry) by supermarket retailers has caused the decline in the number of independent convenience grocery retailers. Moreover, reference to a general decline is misleading, and hides the remarkable success of parts of the convenience sector.

1.8 We address these issues in greater detail in **Parts 2** and **3** of this paper.

### **The High Street**

1.9 The Government introduced the sequential test as part of its “town centres first” policy with a view to protecting the green belt and concentrating development around existing centres. The position was restated in the Barker Review: the sequential test promotes “*the vitality and viability of town centres*”<sup>7</sup>. Some supermarkets – including Tesco – have been flexible in order to comply with this policy while continuing to meet consumer demand for our offering. Our presence can have a positive impact on surrounding businesses due to the increase in footfall resulting from our popularity with customers. Moreover, we proactively engage in urban regeneration – positively promoting town centre vitality and vibrancy. We explore these issues in greater detail in **Part 4** of this paper.

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<sup>7</sup> Barker Review of Land Use Planning, *Final Report – Recommendations*, Kate Barker, December 2006. Executive Summary, paragraph 7.

## **2. THE DECLINE IN THE NUMBER OF INDEPENDENT CONVENIENCE RETAILERS IN CONTEXT**

2.1 A number of grocery multiples have expanded their presence at the convenience end of the market. We believe that this is primarily for two reasons. First, supermarkets saw an opportunity to enter a section of the market with considerable scope to bring innovation and to offer increased choice and better value for money. Second, changes to the planning regime increasingly encouraged a “town centre first” strategy, one that was easiest to implement through smaller stores (although, certainly in our case, we also place greater emphasis on regeneration sites and other opportunities that allow larger stores to be built closer to the town centre)<sup>8</sup>.

2.2 It is these developments that have apparently led to the suggestion that multiple grocery retailers have caused a decline in the number of independent convenience retailers. The focus of such a suggestion has been the entry into this end of the grocery retailing market by the multiple grocery retailers.

2.3 By way of initial observation, there appears to be a tendency, largely unchallenged, to assume that the loss of independent retailers hurts consumers. However, no evidence has been produced that we have seen which demonstrates that the “optimal” number of independent convenience retailers is greater than the existing number of such stores. Without such evidence we fail to see how it is possible robustly to assert that there has been an adverse effect on competition (let alone strip out the significant number of other factors that might have brought about the reduction of store numbers in the first place).

### **A. What has happened to independent convenience retailers?**

2.4 The IGD has reported that the number of convenience stores declined between 2000 and 2005, from 55,798 to 52,085. However, these recent figures disguise some important contemporary features of the sector.

2.5 In particular:

- (a) many independents have not closed, but have joined symbol groups;
- (b) the rate of decline, rather than accelerating as one might expect if assertions about supermarkets in general and their entry into convenience in particular were well-founded, is slowing;
- (c) some segments of the convenience sector have experienced consistent growth over the last few years, including symbol groups, forecourts, convenience multiples and co-operatives;
- (d) the decline in store numbers is not mirrored by a corresponding decline in sector turnover, which is rising more rapidly than any other part of the market; and
- (e) the significant degree of churn in the sector, which is caused by entry as well as exit, demonstrates the vibrancy and competitiveness of the sector.

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<sup>8</sup> We demonstrate the beneficial impact of such a strategy in greater detail in **Part 4** of this paper.

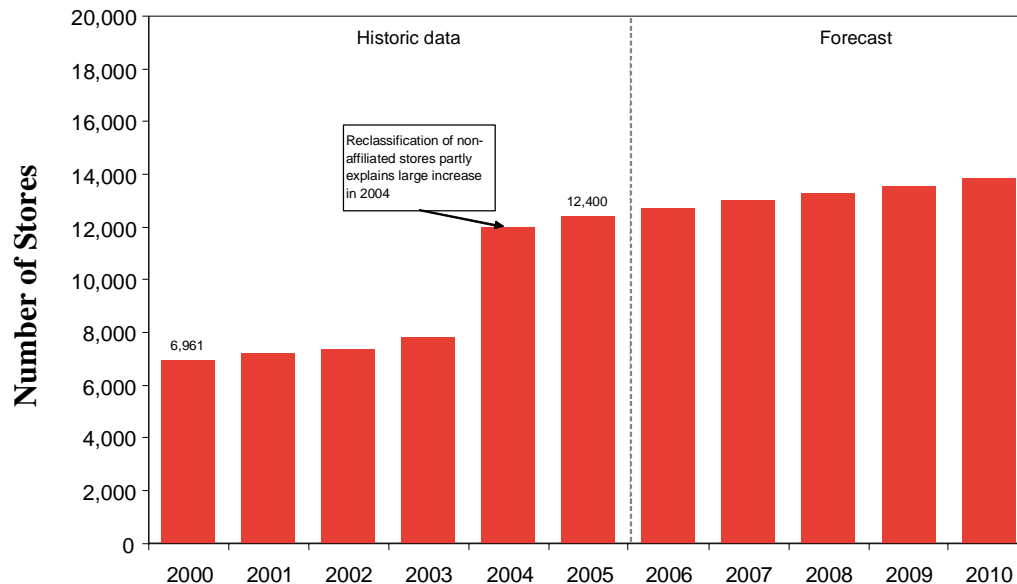
In other words, simply pointing to the fact that the overall number of convenience operators is declining, does not adequately explain the complexity of the market dynamics in this sector.

2.6 Each of the features listed above is described in greater detail below.

***A significant number of independents have joined symbol groups***

2.7 As demonstrated by **Table 1** below, competition within the sector has continued to drive independents towards joining buying groups (known within the industry as symbol groups). The IGD defines symbol groups as independent and multiple retailers that are affiliated to a group operator, usually a grocery wholesaler – indeed, the IGD notes that the majority of the growth is accounted for by wholesale operators, which increased their store numbers by 13.6% during 2005<sup>9</sup>.

**Table 1: growth in symbol groups**



Source: IGD

2.8 This move has tended to improve the overall quality and efficiency of operation of those stores, and has come in response to the intensified competition in the sector. Average sales per store within symbol groups are 125% higher than that achieved in non-affiliated independents<sup>10</sup>.

***Rate of decline is slowing***

2.9 The rate of decline in independent convenience store numbers is slowing. The IGD has reported that the number of convenience stores declined between 2000 and 2005, from 55,798 to 52,085 (6.7% over five years, or an average annual compound rate of 1.37%.) The IGD predicts that this decline will continue between 2005 and

<sup>9</sup> See *Convenience Retailing 2006*, IGD page 15.

<sup>10</sup> *Convenience Retailing 2006*, IGD.

2010, but at a slower rate (4.2% over the five years from 2005 to 2010, or an average annual compound rate of 0.8%). Moreover, the rate of net decline in the number of VAT registered retailers was slower between 2000 and 2005 than it was between 1995 and 2000.

2.10 If it were correct that multiple retailers are the cause of the decline in the number of independent convenience retailers then, with the recent growth in the number of supermarket-owned stores in the convenience sector, one might expect the decline to accelerate. The facts are therefore inconsistent with theory. Instead, although hard to prove, the trend is consistent with our belief that, over the years, retailers have been required to increase efficiency and improve their competitive offer to maintain customer loyalty.

***Some types of convenience retailer are growing***

2.11 As the IGD table below demonstrates, the number of stores in most convenience retailing 'segments' charted by the IGD has been rising. The numbers of symbol, convenience multiple and co-operative stores have all risen – in the case of symbol stores, by 5.1% from 2005 to 2006. In particular, the Co-operative Group has been focusing on delivering the benefits of previous acquisitions. The number of forecourts has fallen slightly, after rising for some years, partly as many oil companies are now diverting their company-owned stores in order to focus on their upstream activities. Nonetheless, average sales per store increased.

**Table 2: Convenience Store Numbers (Estimate) 2004-2006**

	2004		2005		2006		Change 2006-2005	
	No.	% of total	No.	% of total	No.	% of total	Stores (%)	Share (%)
Non Affiliated Independents	29,030	53.1	26,873	50.4	25,893	49.2	-3.6	-1.2
Total Symbols	11,970	21.9	12,400	23.3	13,035	24.8	+5.1	+1.5
Total Forecourts	9,401	17.2	9,301	17.5	8,964	17.0	-3.6	-0.5
Convenience Multiples	2,213	4.0	2,379	4.5	2,427	4.6	+2.0	+0.1
Co-operatives	2,065	3.8	2,321	4.4	2,334	4.4	+0.6	-
Total	54,679	100.0	53,274	100.0	52,653	100.0	-1.2	
Joint Ventures*	1,026		1,189		1,127		-5.2	
<b>Total Convenience Stores</b>	<b>53,653</b>		<b>52,085</b>		<b>51,526</b>		<b>-1.1</b>	

Source: *Convenience Retailing 2006, IGD*

\* Joint Ventures are those sites which are operated jointly between an oil company and a retailer and are petrol filling station based.

Note: Independent convenience store numbers provided by Wm. Reed.

2.12 For completeness, we note that the OFT also referred in its Reference Decision<sup>11</sup> to a Mintel publication that reported that butchers, fishmongers, greengrocers, market stalls and farmshops were trading more successfully in 2005 than in any year since 2000. Mintel goes on to say that “*many of the food specialists that have survived have done so because they have focused on quality and service*”<sup>12</sup>. This accords with our understanding that many specialist stores are performing well.

### ***Total sales are rising***

2.13 Revenues in convenience retailing are forecast to grow substantially over the next five years. The IGD expects total sales in convenience retailing to reach £30.7 billion by 2011 - representing growth of some 23% on 2006 turnover of £24.9 billion<sup>13</sup>. The fact that total revenues are rising as the number of retailers continues to fall implies that those convenience retailers remaining in the market must, on average, be experiencing rising sales. Commenting on this, the IGD states that “*consumer demand for convenience retailing remains strong and although there*

<sup>11</sup> Paragraph 4.6.

<sup>12</sup> See *Food Retailing*, Mintel, November 2005.

<sup>13</sup> IGD, *Convenience Retailing 2006*, pages 4-7.

*may be economic factors which are holding back performance, these are outweighed by competitive factors which are driving performance forward.”<sup>14</sup>*

2.14 Nor is it clear that this growth can be attributed solely to the convenience fascia of grocery multiples, as they simply do not have enough stores significantly to affect this figure. Out of a market size of some 51,526 stores in 2006, the convenience multiples owned only 2,427 stores, or some 4.6% of the total. As the IGD has noted this year, “*Though Tesco and Sainsbury’s have developed convenience operations of their own, overall as a competitor set their presence in this part of the market remains relatively modest*”.<sup>15</sup>

### ***There is considerable churn amongst food retailers***

2.15 As a result of the positive investment conditions described above, there has been ongoing entry into the convenience sector, as well as exit. The sector is perceived to be an attractive one in which to operate (as Verdict has noted, there are “*a wealth of development opportunities for c-stores*”). Using Experian Goad plans, we demonstrate that there is considerable churn amongst food retailers, including significant new entry.

2.16 Experian Goad<sup>16</sup> has produced town centre plans of over 1,000 UK shopping locations. Each plan details the location, name and type of activity of all premises in the surveyed area. By comparing historical plans with more recent ones, it is possible to obtain information on the changes in vacancy rates in the area, as well as in fascia type over the period in question.

2.17 We recognise that there are certain limitations to this analysis, namely:

- (a) the areas surveyed by Experian Goad do not match exactly the one mile/half mile radii previously used by the OFT in the geographic assessment of convenience choice, nor the isochrones used by the CC; and
- (b) Experian Goad only surveys retail “centres” (including town centres, shopping centres and retail parks), and so does not pick up changes in vacancy rates and fascia type for shops outside of these main centres (which is often where convenience shops are located).

2.18 Despite these limitations, we believe that the analysis carried out demonstrates that there is significant “churn” in the broader retail sector and that food retailing is dynamic with new entry.

2.19 Our analysis shows that:

- the total number of retail units in the areas surveyed has remained broadly constant between 2000 and 2006;

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<sup>14</sup> See *Convenience Retailing 2006*, page 112.

<sup>15</sup> See *Grocery Opportunities on the High Street, 2006*, IGD, page 22.

<sup>16</sup> Goad (owned by Experian plc) compiles plans of 1,350 shopping locations in the UK and Republic of Ireland on the basis of surveys of high streets in towns and major district centres. The plans are not an exhaustive representation of all UK shopping areas and as a result, they understate the total number of retail units available.

- within these, there have been changes in usage, with “traditional” retail – both food and non-food – decreasing, and more modern high street activities such as bars and cafés and beauty salons and opticians increasing;
- as a result of the growth in these newer forms of retail, the number of vacant units has declined. However, the vacancy rate makes clear that sites for retail use remain available in these areas;
- overall “churn” is healthy;
- although there has been a small decline in the total number of units in Experian Goad centres dedicated to food retailing, this does not convey accurately what is happening within the various sub-categories of food retailing. For example, “churn” within the convenience sub-class remains healthy, suggesting that it remains dynamic, with both entry and exit occurring over the time period; and
- notwithstanding the small overall decline in the number of units dedicated to food in centres, there are some centres in small- and mid-sized market towns which have experienced a substantial increase in the number of food units.

The findings of this analysis are consistent with our experience that both the retail sector as a whole, and food retail more specifically, are characterised by dynamism and that opportunities for entry remain.

## **B. What has caused the decline in the number of independent convenience retailers?**

2.20 In addition to taking into account the dynamics described in **Section A** above, the exit of some convenience operators should be seen in context. It has been asserted that the decline is caused by anticompetitive behaviour by the supermarkets. However, no evidence has been put to us that this is the case. This is unsurprising, given that the decline is part of a trend that has been taking place for the last 50 years, starting significantly before the entry into the sector by supermarket operators.

2.21 The reason for this decline is explored in greater detail below.

### ***Long-term trend***

2.22 While the number of independent convenience retailers is falling, the IGD states that: “*the decline in the number of non-affiliated convenience stores is the continuation of a longer term trend.*”<sup>17</sup> In her book, *Not on the Label*, Felicity Lawrence suggests that since the 1940s (long before supermarkets in their current form were envisaged), around 100,000 small shops have closed in the UK. The long-term nature of this decline has also been commented on others.

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<sup>17</sup> See *Convenience Retailing 2006*, page 15.

2.23 It seems likely that the decline in the number of convenience retailers – as well as the decline in the number of specialists such as bakers, butchers, greengrocers and fishmongers – is being driven primarily by long standing societal, political and technological change. The end of rationing, the construction of motorways (allowing better distribution), the outlawing of resale price maintenance by the Resale Prices Act 1964, the emergence of bar-code scanning and the rise in car ownership have all affected the business models of both independent convenience stores and specialists, while on the supply side improved techniques in supply chain management and logistics have allowed retailers to better respond to changing consumer preferences. More recently, the rise in the number of working women, single households and the cash-rich/time-poor have meant customers' expectations of convenience stores have become more demanding. These changes have led to the supermarket mode of retailing being preferred to independent convenience stores and specialists through the normal processes of healthy competition and market forces, and have certainly not depended on any anticompetitive behaviour by supermarkets.

### ***More recent factors***

2.24 Most recently, increases in the minimum wage, energy and other operational costs have adversely affected a significant number of small independent retailers. The IGD noted in 2006 that “*operators... face particular trading challenges, including issues of succession planning, increasing staffing costs, the impact of new legislation and the financial requirements of developing a modern convenience offer*”<sup>18</sup>.

### ***National Minimum Wage***

2.25 The National Minimum Wage (the **NMW**) places a direct cost on some retailers. For retailers who previously paid workers at a rate below the statutory level, the NMW has directly increased their operational costs. A report to the Low Pay Commission notes that, “*if the National Minimum Wage imposes higher wage costs on firms and they have no profits to squeeze then some business exits could be expected.*”<sup>19</sup> In addition, the ACS suggested in evidence submitted to the Low Pay Commission that the increase in the NMW (from £3.60 per hour in 1999 to £5.35 per hour now) would put pressure on independent retailers already paying above the NMW. These retailers would need to maintain existing pay differentials to reflect the performance, responsibility and experience of staff.

2.26 Convenience retailers have we are told responded by increasing prices, adjusting the structure of the workforce, making redundancies and reducing investment. Each of these factors is likely to have reduced the ability of convenience retailers to provide a strong overall customer offering and, consequently, their ability to compete in the market.

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<sup>18</sup> See *Convenience Retailing 2006*, IGD, page 6.

<sup>19</sup> See *The Impact of the National Minimum Wage on Profits and Prices: Report to the Low Pay Commission*, Draca, Machin and Van Reenen (2005), page 3.

### *Rising costs of doing business*

2.27 Additionally, in its submission to the Low Pay Commission, the British Retail Consortium (the **BRC**) provided evidence that UK retailers were experiencing increasing operating costs. Whilst the evidence focused on the impact of the NMW, the BRC also suggested that operating costs were rising more generally. As the cost of running retail businesses increases, it is unsurprising that marginal firms may be forced out of business.

- (a) *Energy costs* - the BRC states that: “with energy costs rising by up to 50 per cent, many retailers are expecting their energy contract prices to double in 2006, leaving stark options of settling for much-reduced margins, or reducing costs somewhere else in the business.”<sup>20</sup> Increased energy costs have been driven by the price of gas and electricity, which are closely linked to crude oil prices.
- (b) *Property prices* - the BRC’s evidence to the Low Pay Commission indicated that retailers have, in recent years, encountered rising rents, increased rateable values and increased service charges, all of which contributed to rising operating costs.

2.28 While there is, therefore, plenty of evidence that other factors may be contributing to the decline in the number of independent convenience retailers, we have seen no evidence that would substantiate the view that anticompetitive behaviour by supermarkets has caused that decline.

### ***The limited decline in food retailing units is not driven by supermarket openings***

2.29 As part of our analysis of Experian Goad plans, we have looked at whether there is evidence of a link between supermarket opening near a shopping centre, and the number of units devoted to food retail in that centre. The results of the analysis are consistent with our view that the overall decline in food retailing units is not driven by supermarket opening. Our analysis shows a difference in the decline in food units between those centres which had a new superstore entrant and those which have not. In fact, the larger decline in food units is in centres where no store over 15,000 square feet has opened.

### ***There has been growth in the convenience sector as well***

2.30 As described above, lifestyle changes have significantly altered the dynamics of retailing. However, some of the changes – such as people increasingly shopping close to their home – are likely to have a positive impact on small and independent players, and the High Street. Similarly, as described in greater detail in **Part 5** below, changes to planning policy are likely to encourage those small and independent retailers who are located in town. The Government’s “town centres first” policy, and its subsequent adoption of the sequential test (whereby a town centre site will be favoured for grocery retailing development over and above one that is in an edge-of-town or out-of-town location) has gone some way to protecting traders who are already located in town centres.

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<sup>20</sup> See *Response to the 2006 Low Pay Commission Consultation on the National Minimum Wage*, BRC, September 2006 page 20.

2.31 As described at paragraphs 2.11 to 2.12 above, a number of segments of the convenience sector are thriving.

### **C. The entry into convenience by grocery retailers has benefited consumers**

2.32 The offers that we, Sainsbury and others have brought to the convenience sector are meeting customer needs and demands and providing an enhanced service. Such entry has been approved by the OFT, and the segment's growth is outpacing that of the rest of the UK food and grocery sector. Our Express format is successful because it brings great food at affordable prices into the heart of local communities. These stores are easily accessible and have been welcomed by customers because they have brought precisely those features which customers most wanted to the sector: quality produce, with an increased range of fresh food, at good prices. As a result of these improvements, standards have improved in convenience retailing.

2.33 Other operators in the sector have responded to this increased rivalry. Verdict commented in its recent report that "*The impact of Sainsbury's and Tesco's increasing pressure has raised competition and retail standards. The multiple retailers have brought fresher food, new ranges, lower prices, better store environments and increased scale to the neighbourhood and it has forced smaller players to improve to keep up*"<sup>21</sup>. The convenience sector is now working better in the interests of customers through increased competition, innovation, dynamism and rivalry. The IGD has referred to "*clear evidence of an improving offer across the convenience sector on a whole*"<sup>22</sup>. The Verdict report notes that there is plenty of competition and that the outlook is favourable for the sector<sup>23</sup>. The IGD concluded in 2005 that, "*the c-store sector is now more competitive than ever*", and in 2006 that, "*that the changes that are occurring... are on the whole assisting the growth of the convenience sector through bringing improved performance, store standards and operational efficiencies to a larger group of stores*".

2.34 Ultimately, where Tesco Express and Sainsbury Local are more popular than rival independents, it is because they offer customers more of what they want. We have seen from the 'Hampshire Study', referred to below at paragraph 4.13, that customers much preferred Tesco Express stores to the One Stop stores that they replaced.

2.35 We note that the comments made about our acquisition in 2004 of Adminstore, claiming "*it is an astonishing presumption for Tesco to regard the loss to Londoners of the variety provided by the Harts, Europe and Cullens stores as any kind of convenience*". In response, we would simply note that, after the first year following conversion, the average uplift in the turnover of those stores was 120%, bearing out our view of Express' popularity with customers. Therefore, if there were to be any connection between the growth of convenience multiples and the exit of independents, any decline in the number of independents would simply reflect customer choice: it is competition in action.

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<sup>21</sup> See *Neighbourhood Retailing 2006*, Verdict.

<sup>22</sup> See *Convenience Retailing 2006*, IGD.

<sup>23</sup> See *Neighbourhood Retailing 2006*, Verdict, pages 5-6.

2.36 We note that the CC makes the point in its guidelines that it “*sees competition as a process of rivalry between firms... seeking to win customers’ business over time*”, and considers that “*competition may often be characterised by uncertainty, turbulence and change. Amongst other things, therefore, this process of rivalry may be illustrated by changes in market structure*”<sup>24</sup>. This of course is consistent with John Fingleton’s statement that “*it is not the role of the competition authorities to protect businesses that do not respond effectively to the demands of consumers, or more generally to protect less efficient or less competitive businesses from the rigours of the market*”.<sup>25</sup> The difficulties suffered by underperforming stores – while clearly of great significance to those stores – needs to be considered in this light and in the context of clear evidence that consumers are benefiting significantly and competition is thriving in this sector.

2.37 Moreover, as described in greater detail in **Part 4** of this paper, our innovative and flexible approach has brought significant benefits to consumers by way of urban regeneration and enhanced town centre vibrancy and vitality.

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24 See CC3, *Market Investigation References: Competition Commission Guidelines*, CC, June 2003, para 1.16.

25 Opening statement by John Fingleton before the All Party Parliamentary Small Shops Group inquiry into small shops, 15 November 2005.

### 3. SPECIFIC THEORIES AND BEHAVIOUR

3.1 Part 2 of this paper sets out the facts around the decline in the number of independent convenience retailers, and contextualises this decline.

3.2 No evidence has been put to us to support a view that multiple retailers are responsible, for reasons other than normal competition, for the limited decline in the independent sector. The following sections address certain theories that posit the further loss of independent retailers (among other outcomes) – the tipping point and waterbed theories - as well as specific practices that it is suggested multiple retailers pursue in order to drive competing convenience retailers from the market (i.e. targeted promotions, price flexing and below cost selling).

3.3 It is clear that the theories put forward are speculative and somewhat unreliable. They are also inconsistent with what one observes in the marketplace. We demonstrate below that we do not engage in any of the specific practices cited to a significant level, and that it is neither our intention, nor the effect, that any instance of this behaviour has resulted in the weakening of any of our rivals let alone their exit. We have not seen any evidence to the contrary.

#### A. Tipping Point

3.4 As described in Part 2 above, the convenience sector is thriving. On the basis of this alone, it is clear that the tipping point theory is not a realistic outcome in practice. Indeed, we note that Professor Roman Inderst made this point to the CC at the economic “roundtable” on buyer power.<sup>26</sup>

3.5 We are yet to see any evidence that the tipping point concept is anything other than a theory, in fact the evidence we have seen suggests that wholesalers are doing well. According to the IGD, the grocery wholesaling market grew from £15.3 billion in 2000 to £16.7 billion in 2004, and is expected to reach £18.3 billion in 2009. The Grocer magazine noted earlier this year that, “*the wholesale sector is very much alive and kicking. And there are still plenty of people in the sector who are ready to invest and innovate*”, and that 22 out of the top 30 wholesalers grew in 2005, with seven companies in double-digit growth<sup>27</sup>. We note as well a more recent survey in The Grocer which reveals that 86% of wholesalers expect turnover for the first half of 2006/07 to be higher than the previous year, and 86% expect total profit for the full year 2006/07 to be higher than 2005/06<sup>28</sup>.

3.6 The wholesalers themselves confirm this success. For example, P&H has stated that “*P&H has seen massive growth in sales, sustained in the majority by a move from the niche market supply of confectionery and tobacco to a full, comprehensive range of up to 9,000 lines spanning ambient, chilled & frozen and*

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<sup>26</sup> 10th October 2006 Roundtable: Buyer Power, as published on the CC’s website at [http://www.competition-commission.gov.uk/inquiries/ref2006/grocery/economic\\_roundtables.htm](http://www.competition-commission.gov.uk/inquiries/ref2006/grocery/economic_roundtables.htm). See comments of Prof Inderst on the tipping point (transcript page 34, line 10) – “*I do not believe this is realistic*” and the note by John Davies that Prof Inderst “*found the wholesale tipping argument ‘implausible’*” (transcript page 36 line 4).

<sup>27</sup> *The Grocer*, 1 January 2006.

<sup>28</sup> *The Grocer*, 13 November 2006.

*alcohol sectors*”, and that “*we anticipate continued growth at 4% despite tough conditions*”.<sup>29</sup> P&H told the CC about the investments it was making: “*P&H had expanded its distribution business, developed its Mace symbol brand and added additional ranges... It aimed to be a one-stop supplier to both sell more into its current customers and to expand its customer base.*”<sup>30</sup> We note more generally that 53% of suppliers felt that the purchase of independents by supermarket multiples will ultimately benefit the sector, with only 34% disagreeing.<sup>31</sup>

3.7 Against a backdrop of the convenience sector thriving, the minimal impact of supermarket expansion into the convenience end of the market on wholesalers, and the continuing growth of wholesalers, the tipping point theory is simply not sustainable.

## **B. Waterbed**

3.8 As with the tipping point theory, it is also very difficult against the backdrop of a successful convenience sector to envisage the waterbed effect occurring in practice. At the economic “roundtable”, Dr Thibaud Verge thought the prospect of the waterbed “*unlikely to happen*” while Miguel de la Mano pointed out that “*if the upstream supplier had the ability to raise input prices to convenience stores in the first place, they would have done it already*”<sup>32</sup>.

3.9 It has been argued that supermarket buyer power may result in a dynamic waterbed effect through the exit of grocery suppliers. However, as previously explained in our main submission this conjecture has no theoretical or empirical foundation.

3.10 The same issue was raised in the CC’s 2003 investigation into the proposed acquisitions of Safeway. When asked, the vast majority of small suppliers told the CC that increased buyer power post-merger would not lead them to increase prices to non-multiples. 58 per cent said that their prices to other retailers would not change; 32 per cent said that their prices to other retailers would also decrease; and only 1 per cent said that they would increase their prices to others.<sup>33</sup>

3.11 Nonetheless, it has been argued that, once the waterbed effect is taken into account, consumers as a whole may actually pay more. It is claimed that this happens because:

- (a) customers in other grocery stores pay higher prices sufficient to offset the supermarkets’ better buying terms; but

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<sup>29</sup> [www.palmerharvey.co.uk/ph-about.asp](http://www.palmerharvey.co.uk/ph-about.asp)

<sup>30</sup> Summary of the CC’s hearing with Palmer & Harvey McLane Limited held on 22 September 2006.

<sup>31</sup> See *Convenience Retailing 2005*, IGD, page 81.

<sup>32</sup> Transcript of 10th October 2006 Roundtable on Buyer Power, page 23 (lines 13-16) and page 48 (lines 17-20). Roundtable participants repeated on other occasions that they were not believers in the waterbed effect (e.g. page 47 lines 6-10, page 38 lines 20-21).

<sup>33</sup> CC, Safeway Report, paragraph 6.117.

- (b) customers shopping at supermarkets gain by a lesser amount because supermarkets channel some of the savings from their better buying terms into higher profits.

3.12 The consumer detriment calculation contained in these claims is simplistic and flawed. The estimated detriment of £1.2 billion per annum relies on two speculative assumptions:

- (a) major supermarkets pass on only 50% of cost savings in lower prices; and
- (b) grocery suppliers with no market power have a share of 90% of grocery procurement market.

The available evidence shows that these assumptions are invalid, and – although we do not endorse its model - using more realistic assumptions results in the calculation yielding a substantial consumer benefit.

3.13 This is because the model predicts a consumer detriment only if the proportionate share of grocery suppliers with no market power exceeds the cost-pass through rate for the major supermarkets. The pass-through rate for majors is likely to be close to 100% given the intensity of competition and the fact that gross margins have remained broadly flat since 2000, rather than the 50% assumed byin the model. The CC said in 2000, “...we examined how far and how fast changes in prices paid by multiples to their suppliers were reflected in retail prices... For nearly all combinations of [branded] products and retailers... price and cost changes appeared to be related. ... The econometric analysis of [eight primary products]... suggested that there was rapid and fairly complete price pass-through for most products.”<sup>34</sup>

3.14 As competition in retailing is generally recognised to be stronger than ever (the All Party Parliamentary Small Shops Group concluded that, “the retail sector in general is fiercely competitive.”), there is no reason to think that there is anything other than rapid and fairly complete price pass-through for most products.

3.15 Equally, the share of grocery suppliers without market power is likely to be substantially below 90% given the importance of large branded suppliers and multi-national companies.

3.16 To demonstrate the sensitivity of the model to these assumptions, we have set out below the various outcomes based on other assumptions:

<b>Assumptions</b>	<b>Model</b>	<b>Scenario 1</b>	<b>Scenario 2</b>	<b>Scenario 3</b>
Share of suppliers with no market power	90%	0%	50%	70%
Pass-through of discount by majors	50%	100%	100%	70%
<b>Net gain to consumers £bn</b>	<b>-1.01</b>	<b>2.52</b>	<b>1.26</b>	<b>0.00</b>

<sup>34</sup> CC, Supermarkets Report, paragraphs 7.215-7.226.

3.17 Finally, in relation to both the tipping point and waterbed theories, it is simply not clear that the position of independent convenience store retailers is weakening. On the contrary, 65% of convenience store retailers agreed last year that “*my company is in a stronger position than [the previous] year when negotiating with suppliers*”, with only 10% disagreeing<sup>35</sup>. Such statements are simply incompatible with the assertions being made.

### **C. Targeted Promotions**

3.18 It has been claimed in its submission that multiple retailers target promotions against competitors, with the aim of causing them to exit the market. We do not target competitors in this way. The purpose of these promotions is to encourage customers to visit our new, refitted or under-performing stores, not to drive competitors out of the business. We have not seen any evidence of any market exit as a result of these promotions. Nor would we expect to do so bearing in mind how time-limited they are.

3.19 We run very few local promotions: The promotions that are local are time-limited, short-term and are almost always intended to support newly opened or under-performing stores.

3.20 To take in turn some of the instances alleged publicly:

- (a) our promotions in Belshill, Hull and the Isle of Wight (where we offered discounts to customers who spent over a certain amount) were examples of the local short-term, time limited promotions described in the previous paragraph. We see promotions as an important part of the process of competing to win and retain customers, but the most that a promotional offer can do is encourage a marginal customer to shop in our store once – whether that customer continues to shop with us depends on the quality of our overall offer;
- (b) our actions in Withernsea (allegedly “targeting” the local Proudfoot store) were looked at by the OFT, which – as the Reference Decision acknowledged – concluded that we had no case to answer.
- (c) short-term discounts on tea and coffee in Cleethorpes and Grimsby were not targeted at any particular local retailer,
- (d) the discount cited at our Express store in Piccadilly, Manchester was a limited promotion to publicise the opening of that store.

### **D. Price flexing between formats**

3.21 It has been suggested that we do not pass through to consumers any benefits of what is claimed to be our buyer power in relation to our One Stop shops.

3.22 One such suggestion seems to have reached its view on the basis of comparing the prices of only 13 products between Tesco supermarkets, Tesco Express stores and One Stop stores. Statistically, this is insufficiently robust to be relied upon. We also refer the CC to the comparison carried out by The Grocer magazine, where it found

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<sup>35</sup> IGD, *Convenience Retailing 2005*, page 91.

that – of seven comparable products – three were cheaper at One Stop than at Express, two were the same price, and two were more expensive (although in both cases still cheaper than at Spar).

3.23 Prices in our One Stop stores are different to prices in Express stores because the One Stop operating model is different to the Express operating model. One Stop stores are generally smaller with lower sales densities, but have a similar fixed cost base, hence the pricing structures are different. Despite this, since Tesco acquired One Stop, prices have reduced significantly as part of One Stop’s journey to be best in neighbourhood. We have spent a considerable amount of time, money and effort in reducing prices on a large range of everyday commodities. We have reduced prices on these products by an average of around 12%. We have also worked hard to improve the range available in One Stop, which now offers considerably more fresh produce than previously.

#### **E. Below cost selling**

3.24 Below cost selling by Tesco is not a deliberate strategy or a targeted activity. It is a by-product of intense competition between rival retailers who know that consumers want the best value for money and will switch between retailers if they are unhappy with the relative price offering in one.

3.25 There is significant dynamism in grocery pricing, with prices in-store changing on a weekly – and sometimes daily - basis, depending on for example, supply market conditions, availability and competitor price moves. To give a sense of this dynamism, we check prices of 23,000 products against our major competitors and will manage around 2,500 price changes to our national list each week. It is against this backdrop of constantly changing prices that products are sometimes sold below cost.

3.26 The extent of below cost selling by Tesco, which is the result of a competitive strategy not to be beaten on price, is small. In the 78-week period investigated by the CC, we sold few lines persistently below cost.

3.27 This activity is not targeted at convenience operators, and any effects on smaller retailers are likely to be limited. To support this view, we looked at whether the lines sold below cost in the 78 week period were also sold in our Express stores. Where the products were sold in Express, we also looked at whether they appeared in the list of top selling products in Express. The analysis showed that few of the lines were Value lines or “top 100” selling lines in Express stores. This supports the view that below cost selling in larger stores is not targeted at convenience stores. Moreover, it also supports the view that it does not unintentionally have such an effect.

3.28 More generally, it is possible to overstate the effect of below cost pricing on consumer behaviour. The IGD has noted that, *“data from HIM confirms that customer service and not price alone is the most important factor for the shopper at the independent convenience retailer. In addition, this is also being recognised by retailers themselves, along with other factors such as availability, cleanliness and speed of service”*. This reflects an industry view that perhaps undue consideration can be given to the impact that pricing has on the competitive environment. For example, Jerry Marwood, Managing Director of Spar UK has stated, *“We do not want to sound*

*complacent but price is not the biggest factor”. The ACS echoes this point on its website – “Notice that ‘acceptable prices’ is the 4<sup>th</sup> most important consideration to shoppers”.*

## 4. URBAN REGENERATION AND DIVERSITY/VIBRANCY

### Alignment with planning policy – “town centre first”

4.1 It has been suggested that we, and other supermarkets, develop out-of-town or edge-of-centre sites to the detriment of town centres, and that national planning guidance is biased in favour of large format stores on the edge of town centres. In fact, the key objective of the planning regime – and Planning Policy Statement 6 (*PPS6*) in particular – has been to promote town centre vitality and viability and social inclusion. The Barker Review points out that this is exactly what Government policy was designed to achieve: “*protecting the vitality of town centres is, rightly, an important policy priority*”.<sup>36</sup>

4.2 Tesco has been at the forefront of retailers in aligning our development programme with planning policy to promote “town centre first” objectives. We have taken a flexible approach to store formats, in order to comply with policy guidance for specific locations, and – perhaps more than any one else – we have undertaken land assembly projects for sequentially compliant sites, in order that a store of appropriate size may be brought forward in the right location. Perhaps most importantly when considering planning applications, local authorities are obliged to take into account the key objective of promoting town centre vitality and vibrancy, and are obliged to carry out a retail impact assessment. In other words, Government has ensured that the planning regime has structures in place that seek to ensure vitality.

### Tesco in town centres

4.3 Over the past ten years there has been a marked and conscious change to our business model to ensure that there are no ‘no go’ areas in the UK. This has involved considerable flexibility on our part to ensure a nationwide, cross-format and cross-demographic approach.

#### *Urban regeneration*

4.4 Our town centre presence has allowed us to play an important role in urban renaissance and regeneration, at Woolwich for example. These are examples of projects which the Barker Review has recommended further support for: Barker called on DCLG to “*emphasise the critical role economic development often plays in support of wider social and environmental goals, such as regeneration*”.<sup>37</sup> We are committed to our Regeneration Partnership Schemes, which bring together Tesco, local authorities, the USDAW trade union, the Department of Work and Pensions and others to tackle social exclusion, long-term unemployment and town centre regeneration. We have now completed 17 such regeneration schemes, creating over 4,000 jobs and helping almost 2,500 long-term unemployed and disadvantaged people through our job guarantee scheme.

4.5 An example is our South Wigston, Leicester store. Here, we redeveloped a former factory site in a neglected centre, and as part of a s106 Agreement we funded a variety of improvements to the local area, including improved street paving and

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<sup>36</sup> Barker Review, Executive Summary paragraph 7.

<sup>37</sup> Barker Review, Recommendation 3.

furniture, significant improvements to the roads and to traffic flow, and the introduction of CCTV. We also helped create sink funds for local shopkeepers and community facilities to use to upgrade their premises. Our investment created around 350 full- and part-time jobs, and has led to a much more buoyant centre with increased footfall. Another regeneration scheme recently completed is our store at Burnage, Manchester, which involved the regeneration of a derelict factory site, created 350 jobs and delivered a GP surgery and affordable housing. We are also in discussions to deliver small retail units to help improve the local centre. We have additionally recently opened stores following regeneration projects at the former Deysbrook Barracks in Liverpool and in Glasgow Pollock.

### **Supermarket openings and vitality**

4.6 It has been claimed that supermarket openings lead to reduced vitality in the area in which the supermarket has opened. However, this does not accord with our experience. More often, we see local authorities encouraging a supermarket to enter a location, as it is an attractive “anchor tenant”, bringing increased footfall to an area and positively increasing rather than decreasing its vitality. This analysis is borne out in practice by the experience in relation to our store in Springburn, Glasgow. Here, it has been found that *“the vacancy rate, which is normally taken as a measure of vitality, has reduced over the survey period”*<sup>38</sup>. A very recent example of this is Prestatyn, where the Denbighshire County Council described a Tesco opening as *“an excellent Christmas present for the town”*. The Denbighshire deputy leader Stuart Davies said *“It is excellent news for the town all round and will bring much needed new business into the area”*.<sup>39</sup>

4.7 This is consistent with studies of a number of areas, as described below.

#### *Hampshire example*

4.8 In 2005 a research team from the University of Southampton, completed a survey of consumer responses to changes in the UK convenience store sector. This looked at the shopping behaviour and opinions of consumers in four communities in Hampshire following the conversions of One Stop convenience stores into the Tesco Express format. The study found there was broad-based local community support for the improved local food shopping offered by the Tesco Express stores. In particular: ‘top-up’ food shopping had shifted away from supermarkets towards local stores; more people were walking or cycling to do their shopping, leading to a decrease in car use; and 60% of customers felt that the range of fruit, vegetables and other foods had improved.

#### *Seacroft example*

4.9 Consumers have benefited as well from our investments in community schemes, as a number of external studies have shown. Southampton University published in 2002 Deprivation, Diet and Food Retail Access: Findings from the Leeds

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<sup>38</sup> See *Large-Scale Food Retail Interventions and Diet*, Medical Research Council/Department of Health, 2004.

<sup>39</sup> See BBC news article dated 23 November 2006, located on the BBC website at [http://news.bbc.co.uk/1/hi/wales/north\\_east/6177920.stm](http://news.bbc.co.uk/1/hi/wales/north_east/6177920.stm)

“Food Deserts” study. This reported on a cross-disciplinary project involving Southampton, Leeds and Cardiff Universities funded by the Economic and Social Research Council (*ESRC*) and Sainsbury. This studied the local population in Seacroft, Leeds, before and after the opening of our first regeneration store. This came to what at the time was a surprising conclusion:

*“.....the findings of the Seacroft study reported here suggest that a large-scale corporate intervention can significantly change shopping access and travel mode for large numbers of residents of such areas. (Recall here that 45% of our respondents in this large deprived area of 15,000 households switched to the new store as their main food source – in the process, more than halving the average distance travelled (from 2.25 to 0.98 kms) to that source, tripling their use of walking, and significantly reducing their dependence on complex, and often hard to manage, coping mechanisms to access food shopping). In addition, our findings provide evidence of both direct and indirect positive impacts of the large-scale intervention on the diets of some (indeed some of the more “at risk”) groups in the “food desert””*

#### *Beverley example*

4.10 Another study by independent planning consultants carried out for the local authority in Beverley in 2003/04 found that the new Tesco store in the historical market town had stimulated the local economy. It found that two-thirds of customers at the Tesco store also visited other stores in the town centre. Local business leaders also said that it had boosted Beverley’s reputation as a popular shopping destination.

#### *Tesco and sustainability*

4.11 More widely on sustainability, we are showing leadership through a series of projects and programmes to reduce our energy use and greenhouse gas emissions, and to generate our own energy through renewables and low carbon technology. We announced a £100m fund in 2006 to roll-out sustainable environmental technology within the business, and we are designing model ‘energy efficient stores’ which use state-of-the-art technologies, renewable energy generation and energy efficient practices.

4.12 Despite the weight of evidence described above, a number of specific accusations have been made suggesting that a Tesco opening has damaged an area. In particular, it has been claimed that in Stalham and Chepstow, supermarket openings drained vitality away from town centres to an extent that created a need for regeneration. This is simply not the case.

#### *Stalham*

4.13 Before we opened a store in Stalham, North Norfolk District Council had identified the need for a supermarket in the town. The town had been facing many challenges with the decline of Stalham markets in the 1970s and 1980s. Many shoppers were also being attracted away from Stalham by supermarkets in other towns. With fewer visitors the High Street suffered and the Council recognised the need to reverse this trend. The Tesco store has proved popular in this regard. We offer free parking and there is a pedestrian walkway linking the car park to the High Street.

4.14 Stalham is an example of how Tesco has increased competition in a town and encouraged local retailers to improve their offer to the benefit of consumers. Customers have stated that Tesco has been a welcome addition to the town, but they also continue to shop at local specialist retailers. Residents have commented that, since Tesco opened in the town, there have been increased visitor numbers to the area and the High Street and that some retailers on the High Street have experienced an increase in revenue. They recognised the extra employment opportunities and were pleased that there was a reduced need for local travel further a field.

### *Chepstow*

4.15 We would entirely reject any claim that – as a result of our opening – Chepstow requires regeneration. If there is any requirement for Chepstow to be modernised, it has more to do with the steep town centre streets and minimal pedestrianisation that led to the conclusion in the Retail Background Paper to the Monmouthshire Unitary Development Plan that, “*overall the town suffers from a poor pedestrian network*”. It was this that led to a £1.7 million investment by Monmouthshire County Council for the enhancement of Chepstow High Street. Subsequently, in November 2005, Chepstow was named the Gold Standard winner of retail property organisation BCSC’s 2005 Town Centre Environment Awards for its High Street regeneration work. This was the fourth award for the Chepstow scheme after winning the Local Government News Street Design Award (Pedestrian Environment), the Worshipful Company of Paviers “Award for Paving, 2005” and being chosen as the runner-up in the Institute of Civil Engineering (Wales) Roy Edwards Award for small projects.

### **Safeguarding communities**

4.16 As we work with local authorities to promote the vibrancy and vitality of town centres, we frequently provide specific amenities in conjunction with our stores to encourage people to visit our stores in conjunction with the High Street. In doing so, we deliver a “*range of direct and indirect benefits*” of the sort which Barker has urged DCLG to emphasise in national planning policy.<sup>40</sup> We work to safeguard local centres, not just because we care about the communities in which we operate, but also because our customers do. There is absolutely no incentive for us to damage the communities in which we are located, as they would be less appealing to customers.

4.17 There are a number of ways, in addition to the broader regeneration projects described above, in which we have sought to improve town centres. For example, at Bordon, we contributed ● toward an improved bus service. At our Slough Extra store, we have gone to considerable lengths to ensure customers could make linked trips to the town centre: we built a footbridge linking shoppers directly to the town centre, and we offer free parking to encourage shoppers who drive to our store to visit the High Street. Our customers tell us that this has worked, and that shoppers are using the parking facility to make such linked trips.

4.18 Some correspondents to the CC’s website have raised concerns about the impact of changes in the structure of retailing on particular social groups such as the old, the infirm and the car-less. We recognise the importance of affordable,

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<sup>40</sup> Barker Review, Recommendation 3.

accessible food for all sections of the population and for all communities. Although for the most part solutions must lie with other bodies, a number of developments of our business are making inroads into the problem. We have opened Express stores in local neighbourhoods (10-15% of our Express estate is in rural areas), in some cases thereby providing a source of affordable, fresh food for people without access to cars. Our dot.com service is very popular, equally so with busy urban families as with people in rural communities. It has allowed many house-bound people to take control of their grocery shopping, sometimes for the first time.

*Submitted 15 December 2006*