

ASSOCIATION OF CONVENIENCE STORES

**MAIN SUBMISSION TO THE
COMPETITION COMMISSION INQUIRY
INTO THE GROCERY MARKET**

September 22nd 2006

This paper has been produced by the Association of Convenience Stores Limited (ACS), which is supported in the current inquiry by the Scottish Grocers' Federation (SGF), the Northern Ireland Independent Retail Trade Association (NIIRTA) and the Federation of Wholesale Distributors (FWD)



Association
of Convenience
Stores

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- 1.9 The anti-competitive elements of Big Four supermarket trading practices arise from market failure. It follows that the market by itself will not find suitable remedies and that intervention by the competition authorities will be necessary. Remedies need to be devised that provide fair and effective competition between different retailer types without damaging consumer interests and without requiring an excessive burden of policing.
- 1.10 If no action is taken to curb abuses arising from the combined buyer and seller power of the Big Four supermarket groups, the ability of other retailers to compete against them, and especially the ability of small retailers to compete at a local level for local consumers, will be irreparably damaged.

2 ACS, ITS MEMBERS AND NON-MEMBERS

The Association of Convenience Stores

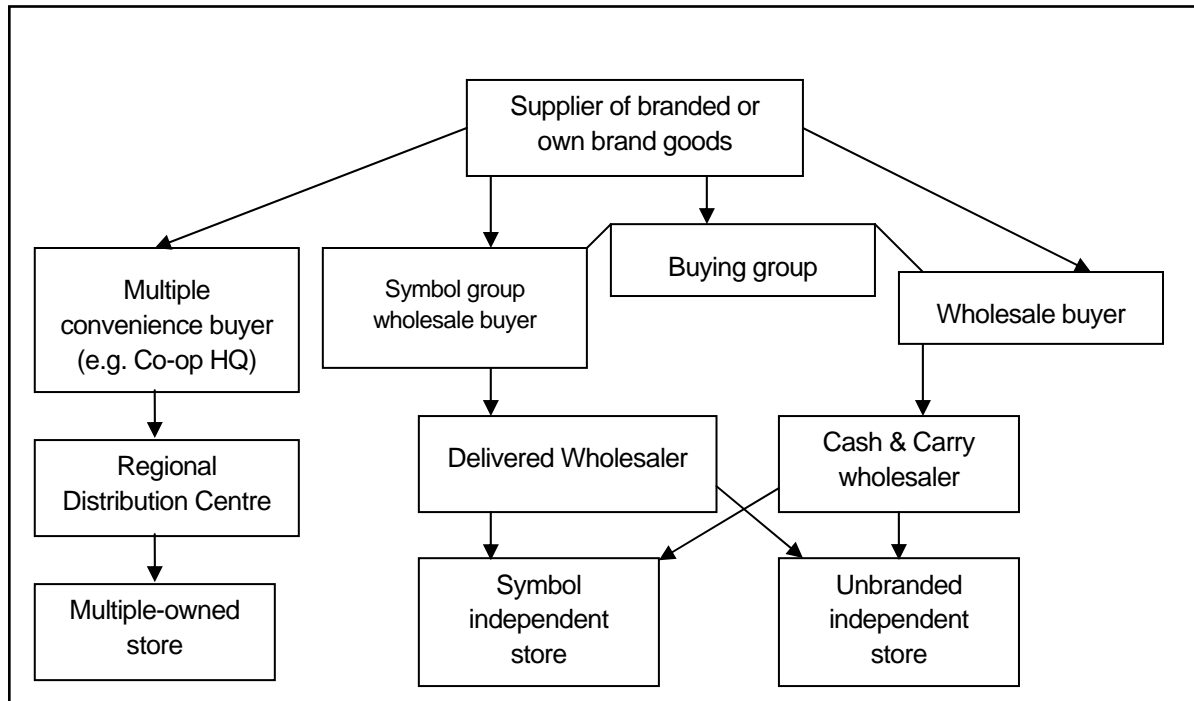
- 2.1 ACS (hereinafter “we” or “us”) is the principal trade body representing UK convenience stores. We exist to represent the interests of our members before policymakers rather than to provide a clearing house of sector information. Although we acquire a great deal of knowledge about the sector as a whole, our ability to provide financial information on individual convenience stores or groups of stores is very limited.
- 2.2 We were established in our present form in 1995, following mergers of earlier trade bodies, and now represent over 32,000 convenience stores, roughly 60 per cent of the estimated UK total of between 51,000 and 52,000.³
- 2.3 Although we are by some way the largest representative body for convenience stores, we are not the only such body. Large numbers of our members are also members of other bodies, particularly the National Federation of Retail Newsagents (NFRN).
- 2.4 Because we have no means of distinguishing the interests of ACS members from those non-members who also operate convenience stores, we propose throughout the inquiry to offer evidence and argument for the convenience store sector as a whole. It seems to us highly unlikely that the interests of members and non-members differ.

Retailers and wholesalers

- 2.5 Also among our larger members are wholesalers, some of whom own or operate convenience stores. The wholesale members are in general members not only of ACS but also of the Federation of Wholesale Distributors (FWD).
- 2.6 Because the structure of the convenience sector is somewhat complex, we set out in Figure 1 a diagram of trading relationships in what is often loosely referred to as the “convenience store sector”.

³ Source: IGD, *Convenience Retailing*, 2006

Figure 1: supply chain in the “non Big Four” convenience store segment



2.7 The following points are important in relation to Figure 1:

- in the convenience segment almost all goods are supplied by the manufacturer to the wholesaler or retailer; they are generally not collected by the buyer.
- some suppliers deliver goods, especially fresh products, direct to independent or multiple stores.
- newspapers and magazines too are delivered direct, by separate wholesalers contracted to the publisher.
- the diagram does not imply that all wholesalers or symbol groups are part of a larger buying group.
- some buying groups do not physically handle the products they buy but arrange for them to be transported directly to members of the group.
- although there is no hard-and-fast rule, unbranded independent stores are likely to be supplied primarily through cash & carry outlets, while symbol group stores are likely to be supplied primarily by those wholesalers which offer a delivery service (“delivered wholesalers”).

- 2.8 Members of symbol groups are generally independent businesses. The symbol group exists primarily to provide branding, buying and certain other support services. We provided an example of what a symbol group characteristically does in the Statement of Issues sent to the Commission on June 6th.
- 2.9 As we have already advised Commission staff, it is the independent, unaffiliated businesses that are hardest to engage in the current inquiry. Even if effectively contacted, they might not have detailed sales or cost information readily to hand for the Commission's purposes. It is also hard to imagine how the Commission could deal with the several thousands of responses it might receive.

Specialist grocery outlets

- 2.10 We do not represent specialist retailers such as butchers, greengrocers, bakers or fishmongers. These are not convenience stores as generally defined (see Section 3 of this document) and are therefore represented by other trade bodies.
- 2.11 Nevertheless, such outlets are an important part of the grocery market, although their number have been in long-term decline. The Knowledge Store estimates that there are some 8,000 greengrocers, 7,500 butchers, 3,800 bakers, 3,400 farm shops, 600 fishmongers, and about 1,000 others, collectively the equivalent of more than half ACS' own membership.
- 2.12 ACS members have many issues in common with these types of retailer, and we expect to liaise informally with them during the course of the Commission's inquiry.

3 CONVENIENCE RETAILING AND THE CONVENIENCE STORE SECTOR

Market definition

- 3.1 A detailed examination of market definition based on econometric analysis is outside the scope of this submission. We have therefore considered a number of market definitions, including those employed by the OFT and the CC, in order to arrive at a working definition suitable for use in a response to the current investigation. We do not argue one definition of “the convenience sector” or “the convenience store sector” which we suggest makes all others wrong. Indeed, we acknowledge entirely that, in grocery as broadly defined, market definition can be problematic.

The product market

- 3.2 Definition of the product market – the range of goods which properly fall into the category “grocery” – is perhaps not too contentious, although we acknowledge that it shifts over time.
- 3.3 ACS and IGD define a convenience store as one which stocks products in at least seven of the following groups: alcohol, bakery, chilled food, confectionery, fast food/food-to-go, frozen food, fruit and vegetables, health and beauty products, household products, Lottery, milk, newspapers/magazines, packaged groceries, snacks, soft drinks, tobacco. We would regard grocery as encompassing all these categories.
- 3.4 In making its reference to the Competition Commission, the OFT defined “grocery” rather more narrowly, as “...food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods”. (Annex A, page 87). It excluded two product categories which play a vital part in the economics of a convenience store, namely newspapers and magazines and tobacco and tobacco products.
- 3.5 We welcome the fact that the Commission has said⁴ that it will investigate connections between grocery and other products which may influence consumers in where they purchase grocery. This, we believe, should effectively reconcile differences between the OFT’s definition and that of the trade. A further instance is the supply of fuel in larger supermarkets on terms which we contend are intended to impact grocery purchasing.

The geographic market

- 3.6 As regards the geographic market, the diversity of shoppers’ habits and the types of store in which they exercise their shopping preferences make for considerable complexity.

⁴ At an introductory meeting to the inquiry held on May 19 2006.

The CC approach

- 3.7 In its 2000 report on supermarkets, the CC used a binary definition of consumers' grocery shopping behaviour: It defined shopping as either "one-stop" or "top-up" and defined supermarkets as stores of 1,400 square metres (13,500 square feet) or above providing one-stop grocery shopping. The CC concluded that ASDA, Morrison, Safeway, Sainsbury's and Tesco were "able to exercise power in this market".⁵
- 3.8 Subsequent competition investigations in the grocery sector, principally the Morrison's acquisition of Safeway, led to refinements of the definitions used in 2000.⁶ In its 2003 report the CC stuck with its reliance on the concept of "one-stop" shopping and with its definition of supermarkets as stores above 1,400 square metres providing one-stop shopping, but it sub-divided smaller stores into convenience stores (up to 280 square metres, equivalent to approximately 3,000 sq. feet) and other stores (between 280 and 1,400 square metres) which were seen as providing "secondary" or "top-up" shopping.

The OFT approach

- 3.9 The OFT subsequently (and in our view usefully) developed market definition further, principally by recognising that the behaviour of consumers is of greater relevance to market definition than the floor areas of different types of stores, or indeed than different types of store, whatever their size.
- 3.10 In assessing the acquisition of T&S Stores and Adminstores by Tesco and the acquisition of Jacksons by Sainbury's, the OFT argued that:
- "The appropriate frame of reference for considering the competition constraints would ... appear to be **convenience retailing, including secondary shopping from supermarkets** [*our added emphasis*] but excluding small shops that do not meet the Mintel/IGD criteria [for definition as convenience stores]"
- 3.11 The important point here is recognition that supermarkets compete with other smaller stores for convenience shopping, and that the market definition therefore needs to encompass convenience retailing both in convenience stores and in supermarkets. In its assessment of the T&S acquisition, the OFT quoted an estimate by Tesco that around 15-25 per cent of shoppers' spending in its supermarkets could be characterised as secondary shopping.
- 3.12 In analysing whether acquisitions of convenience stores might give rise to competition concerns at a local level, the OFT sought to identify individual stores where the number of competing outlets in the local area (whether convenience stores or supermarkets) would

⁵ *Supermarkets*, CC, October 2000, Cm 4842, paragraph 1.5.

⁶ *Safeway plc and ASDA Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc*, CC, October 2003, paragraph 1.8.

be reduced to two or fewer as a result of the acquisition. In assessing the T&S acquisition, the OFT assumed that convenience stores had a catchment area of one mile radius. In subsequent cases, this was refined and a smaller catchment area of half a mile radius was used for stores in densely populated areas.

- 3.13 In Spring 2006 Harris International Marketing, undertaking a (routine) survey⁷ of convenience store customers' shopping habits, established the following pattern of travel:

	Average c-store shopper	Ave Independent store shopper
Less than 100 yards	20%	23%
Less than ¼ of a mile	29%	32%
¼ to ½ a mile	14%	14%
½ to ¾ of a mile	4%	4%
¾ of a mile to 1 mile	7%	6%
1 to 2 miles	9%	8%
2 to 5 miles	7%	5%
5 to 7 miles	2%	2%
7 to 10 miles	2%	1%
10+ miles	6%	4%

- 3.14 In other words, 63 per cent of shoppers travel no more than 0.5 miles to get to a convenience store of any type, and 69 per cent no more than 0.5 miles to visit an independent convenience store.
- 3.15 The same survey found that 49 per cent walk to convenience stores overall, and 53 per cent to independent stores.

The approach of IGD

- 3.16 The Institute of Grocery Distribution (IGD), along with others in the industry, uses the more restricted definition of "retailing in convenience stores". Thus, in its report on consolidation in convenience retailing, the IGD's statement that "the UK convenience grocery retailing sector currently generates sales of £23.0bn per annum" does not take account of convenience shopping in supermarkets.⁸
- 3.17 The criteria that IGD uses in deciding whether a retail outlet counts as a convenience store are as follows:

⁷ Convenience Tracking Programme, Spring 2006

⁸ IGD, *Consolidation in Convenience Retailing: Examining the Implications*, December 2004, p.171.

- (a) the store must be below 280 sq m. This size threshold is important since stores over 280 sq. m. are prohibited by law from opening for more than six hours on a Sunday (in effect depriving them of a key “convenience” characteristic);
 - (b) the store must sell retail food and drink, for consumption off the premises, as its main business activity;
 - (c) the store must sell at least eight out of a list of fifteen core product categories.⁹
- 3.18 IGD’s categorisation of stores and what they sell was not, it seems to us, intended as a formal definition of an economic market for competition purposes. However, it is important to be aware of what market IGD is referring to when figures from its report on consolidation are quoted.
- 3.19 IGD also distinguishes different types of shopping activity that take place in convenience stores.¹⁰ It refers to three – top-up shopping, distress shopping and impulse shopping.
- 3.20 The primary market definition question for the CC to consider is therefore whether “convenience retailing” is a relevant economic market. For the purposes of this report, we argue that it is a relevant market but not, in such a wide-ranging investigation as this, exclusively so. Defining “convenience retailing” as a relevant market is implicit in the CC’s distinction between “one-stop” and “top-up” shopping and in the IGD’s three sub-divisions mentioned above. It is explicitly recognised by the OFT in its analyses of the Big Four supermarket acquisitions of T&S, Adminstore and Jacksons.

In summary...

- 3.21 Our view is that earlier market definitions advanced by the CC and OFT have necessarily evolved as the diversity and complexity of consumers’ shopping preferences have become better understood. The definition we advance here – or rather definitions, since we think it vital to distinguish retail from wholesale – is not necessarily the one right definition that makes all others wrong.
- 3.22 We conclude that the geographic market is distinct at retail and wholesale levels.
- 3.23 The geographic market for wholesale groceries may well be national, given that wholesale buyers normally buy at a single national price, no matter where the goods are made or delivered. The FWD has confirmed that wholesalers supplying the independent trade purchase on terms which apply nationally, and we understand from suppliers that supermarket buyers do likewise.

⁹ Alcohol, confectionery, fast-food/food-to-go, fresh fruit/vegetables, frozen/chilled foods, household/non-food, milk/dairy, National Lottery (any game), newspapers/magazines, bread/bakery products, health and beauty aids, packaged groceries, savoury snacks, soft drinks, and tobacco.

¹⁰ IGD, *Consolidation in Convenience Retailing: Examining the Implications*, December 2004

- 3.24 There are good arguments for suggesting that the retail market for groceries is not simply a single national market but a large number of local markets, albeit that the word “local” is itself definable in different ways. In certain respects, grocery retailers in Aberdeen are not much influenced by retailers in Penzance.
- 3.25 This is not to suggest that those players who operate on a national scale do not take a national view of strategic or near-strategic matters, for example new store locations, product range, acquisitions and corporate finance. Our point is that at what Professor Paul Dobson refers to as the “micro-marketing” level, local flexibility among the Big Four supermarket groups is evident.

Market overview

Market size

- 3.21 The UK retail market for all grocery retailing in the year to April 2006 was assessed at £124 billion.¹¹ The extent of retailing through convenience stores (regardless of ownership) for the same period was assessed by IGD at £24.8 billion, leaving just under £100 billion as the retail revenue flowing through supermarkets and all other grocery stores, whether above or below 280 square metres. The OFT recorded in its assessment of the acquisition of T&S a comment from Tesco that between 15 and 25 per cent of its sales at retail level (the precise figure was confidential) were classified as secondary shopping. If we assume the actual figure is 20 per cent, and that it also applies to other multiples, then we might surmise that the supermarkets and other grocery stores have convenience retailing revenue of about £20 billion. Harris International Marketing has estimated a figure of £15 billion per annum for “top-up (or convenience) sales taking place in supermarkets”.¹²
- 3.22 In very round terms, therefore, we assess the turnover in convenience retailing at about between about £40 billion and £45 billion per annum. IGD reports that recent revenue growth in convenience stores has outstripped growth in grocery sales overall. Between 2005 and 2006, convenience store sales grew by 4 per cent compared with 3.4 per cent for grocery as a whole.

Types and market shares of players

- 3.23 IGD usefully breaks convenience stores down into five types:
- non-affiliated independents;
 - symbol stores (those which operate under common fascias, most independently owned but with some owned by the symbol owner);

¹¹ Source IGD

¹² Harris International Marketing, *Convenience Shopping in Supermarkets*, 2006

- forecourts (stores on the forecourts of filling stations);
 - convenience multiples (including convenience stores owned by supermarkets as well as by groups which might own wholesaling and distribution facilities as well as retail shops);
 - Co-operatives.
- 3.24 To these categories we add supermarkets and other stores above 280 square metres, on the grounds that they represent, at least for some consumers, outlets for convenience shopping.
- 3.25 IGD estimates the share of revenue of each type of outlet, based on total revenue of £23 billion. If we add £20 billion of revenue to cover convenience shopping in supermarkets and other stores, and adjust all other market shares to reflect the greater size of the market, the following shares emerge:

Table 1: estimated convenience retail revenue by outlet type

Outlet type	Estimated sales (£m) y/e Apr. 2006	Estimated share (per cent)*
Non-affiliated independents	7,251	16
Symbols	8,222	18
Forecourts	3,741	8
Convenience multiples**	3,079	7
Co-operative stores below 280 sq.m.	2,561	6
Estimated convenience shopping in supermarkets and other stores	15,000 to 20,000	45
Total (rounded)	40,000 to 45,000	100

**based on £45 billion total sales*

***Convenience multiples include convenience stores owned by supermarkets, but not those owned by Co-ops, which are shown one row below*

Source: Europe Economics from IGD and OFT

- 3.26 Table 2 gives a breakdown of numbers of stores by type.

Table 2: numbers of convenience store outlets (max. 280 sq. m.) by category

Outlet type	Estimated number April 2006	Share of total (per cent)
Non-affiliated independents	25,893	50
Symbols	13,035	25
Forecourts (note 1)	7,837	15
Convenience multiples (note 2)	2,427	5
Co-operative stores < 280 sq.m.	2,334	5
Total	51,526	100

Note 1: The figure of 7,837 is net of 1,127 joint ventures.

Note 2: Convenience multiples include convenience stores owned by supermarkets, but not those owned by Co-ops, which are shown one row below.

- 3.27 Ignoring the specialist outlets, from Tables 1 and 2 we can derive average revenues by type of store, as set out in Table 3. The wide range of revenues is striking.

Table 3: average revenue by outlet type

Outlet type	Total est. revenue (£m) y/e Apr. 2006	Estimated no. Apr. 2006	Average revenue per outlet (£ p.a.)
Non-affiliated independents	7,251	25,893	280,000
Symbols	8,222	13,035	631,000
Forecourts	3,741	7,837	477,000
Convenience multiples	3,079	2,427	1,269,000
Co-operative stores <280 sq.m.	2,561	2,334	1,097,000
Estimated convenience retailing in supermarkets and other stores	20,000	6,401	3,124,000
Total	44,854	57,927	774,000

Source: Europe Economics from IGD, The Knowledge Store, OFT

Ownership of convenience stores by multiples

- 3.28 The ownership of stores under 280 square metres by the multiples is easily summarised. In the following discussion we include references to garage forecourts operated in partnership with petrol retailers (note that these would come under “forecourts” rather than “convenience multiples” in IGD’s breakdown of the market). In addition, some supermarkets also own garage forecourts on filling stations attached to their own supermarkets, and these are not listed below.

- 3.29 Ownership by the Big Four supermarket groups, in descending order of numbers of stores, is as follows:¹³
- (a) Tesco owns 1,150 convenience stores. These are a combination of Tesco Metro, Tesco Express, together with One Stop and Day & Nite shops acquired from T&S and undergoing conversion to a Tesco format. Tesco thus owns 47 per cent of convenience multiples if we exclude those operated by the co-operatives (as William Reed does), or 23 per cent if we include them. Tesco owns 406 forecourt stores and operates a further 130 in partnership with Esso. This total of 536 makes Tesco one of the two largest operators in the forecourt segment, just behind Total, with its 537.
 - (b) Sainsbury's owns 287 convenience stores (branded "Local", Bell's or Jacksons), owns 243 forecourt stores and operates 24 forecourt shops operated in partnership with Shell.
 - (c) Morrisons owns 274 forecourt stores but has no other presence in the convenience store sector..
- 3.30 In the forecourt segment the oil majors collectively are the largest owners of forecourt convenience stores: Esso owns 631, Shell 611, Total 537 and BP 414. Given the presence of the grocery multiples in forecourt stores, the whole forecourt segment remains relatively unconcentrated.
- 3.31 There are 2,334 co-operative stores of up to 280 sq. m., owned by co-operative societies. The largest such entity, the Co-operative Group, owns 1,240 (53 percent), and United 445 (19 percent), with the remaining 28 per cent owned by more than twelve other regional societies.¹⁴ The Co-operative Group, which had owned and operated convenience stores for some years previously, acquired Alldays in 2002, then Balfour in 2003, and Conveco in 2004. The effect of these acquisitions, even after some disposals, more than doubled the Co-operative Group's presence in the sector.
- 3.32 In Table 4 below we summarise by ownership group, in descending order of numbers of outlets, convenience stores owned by the largest multiples. The list details groups owning a minimum of 100 stores, then all others combined.

¹³ Source: IGD

¹⁴ Co-operatives also own a total of 911 stores above 280 sq. m.

Table 4: convenience multiple stores ranked by ownership group

Ownership	Number	Per cent
Co-operatives (all societies combined)	2,334	49
Tesco (Tesco Express, One Stop and Day&Nite)	1,150	24
Martin McColl	323	7
Sainsbury (Local, Bell's , and Jacksons)	287	6
Whistlestop	100	2
All others combined	567	12
Total	4761	100
Top 5 fascia owners (4194) as a percentage of total (4761)		88

Note: The One Stop and Day & Nite stores were part of the T&S group acquired by Tesco. We understand that, after certain disposals, Tesco is converting the majority of these stores to a Tesco fascia and format.

Source: IGD

Big Four supermarket acquisitions of convenience stores

3.33 Tesco and Sainsbury have established their respective positions relatively rapidly. Tesco acquired T&S Stores in early 2003, and Adminstore in 2004. Sainsbury acquired Jacksons in 2002, J B Beaumont and Bells Stores in 2004 and SL Shaw in 2005. None of these transactions was referred to the CC.

3.34 Table 5 gives such detail as is publicly available of supermarket acquisitions in the convenience store sector.

Table 5: Big Four supermarket convenience store acquisitions

Date	Acquiring business	Acquired business	No. stores	Est. ave. t/o per store (£m.)
Jan. 2003	Tesco	T&S Stores	1,215	2.1
Feb. 2004	Sainsbury	Bells Stores	54	1.0
Mar. 2004	Tesco	Adminstore	45	1.6
Aug. 2004	Sainsbury	Jacksons	114	1.3
Nov. 2004	Sainsbury	Beaumont	6	2.2
Apr. 2005	Sainsbury	SL Shaw	5	2.2
Total			1,439	ave. 1.98

Sources: IGD, company press releases and annual accounts, and Christie & Co estate agents Business Outlook 2003, 2004, and 2005.

3.35 We estimate that Tesco and Sainsbury between them now have a substantial slice of the highest turnover convenience stores in the UK. We base this calculation partly on Table 5, which indicates that a total of 1,439 stores were acquired, and partly on the William Reed *Independent Grocery Retail Database* for 2006, which records that there are now left a total of 968 convenience stores turning over between £30,000 and £100,000 per week, and 212 stores turning over between £100,00 and £1 million per week.

Tesco's comments about convenience retailing

3.36 Tesco has, since 2001, consistently told shareholders about its intention to achieve a substantial showing in convenience retailing. The following quotations are from successive Annual Reports.

3.37 2001:

"In the year we opened 48 new stores comprising four Extras, nine Superstores, 16 Compacts, one Metro and 18 Express stores."

3.38 2002:

"This year we opened 30 Express convenience stores, bringing the benefit of our customer focus and value to many more communities, and are rolling these out at a rate of over one a week."

3.39 2003:

"We [also] acquired 1,202 T&S Stores, a leading convenience retailer, giving us an additional 1.8 million sq ft. This acquisition increases our share of the convenience market from 1% to 5%. We will convert 450 T&S stores to our Express format over the next three to four years bringing the Tesco range and offer to many more customers in neighbourhood locations."¹⁵

3.40 2004:

"We have a strong and accelerating organic growth strategy in the convenience market. Next year we will open 31 new stores and convert 194 T&S stores, giving us a total of over 500 convenience shops. In January we announced we were acquiring 45 convenience stores from Adminstore Ltd. We will be converting most of these stores to our Express format. This allows us to accelerate our growth in Central London where we do not have many Express stores and bring lower prices, improved service and better ranges to even more customers."

3.41 2005:

"...even more customers are now benefiting from the convenience of having Tesco in their neighbourhood. Twenty six of these stores are new sites, while we also continued with our conversion programme of Adminstore shops in London (Cullens, Europa and Harts) and of T&S."

3.42 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.

¹⁵ We should add that Tesco sold, soon after acquisition, T&S' Supercigs branded stores and Dillons newsagents.

3.43 It is also interesting that Tesco is able to expand significantly the scale of operation of acquired stores. Its 2005 Report and Accounts records, in relation to the Adminstore acquisition:

“On average, these stores have seen sales more than double and are nearly 20% above our forecasts.”

Sainsbury’s comments about convenience retailing

3.44 Sainsbury has been no less forthcoming than Tesco about what it sees as the attractions to consumers of its own presence in convenience stores, although it has pursued expansion through organic means rather than through large-scale acquisition. Its Annual Reports refer to convenience retailing in the following terms.

3.45 2000:

“[Sainsbury’s] Locals aim to succeed by bringing a quality and value for money option into the large convenience store market, and we plan to open 25 more in the year ahead....Last year we opened 20 stores (including four Locals), extended 22 and refurbished 16. We will be accelerating this work, building 13 new supermarkets, 25 new Locals, extending 35 stores and refurbishing 15 this year...”

3.46 2001:

“We also opened 14 new supermarkets and 13 new Locals during the year....Sainsbury’s Local 3,000 sq ft convenience stores [are] for daily and top-up shopping as well as snacks and sandwich lunches. Sainsbury’s is also trialling five Locals combined with Shell branded petrol stations...”

3.47 2003:

“During the year we opened 15 new supermarkets and 24 Locals...”

3.48 2004:

“We acquired ...Bells Stores, a chain of 54 neighbourhood convenience stores....During the year we opened 10 new supermarkets and 16 were refurbished or extended. We also announced plans to open Sainsbury’s Local stores on 100 Shell petrol station forecourts. With the acquisition of 54 Bells neighbourhood convenience stores in north-east England, we now have 146 convenience stores.”

3.49 2005:

“...in August 2004, the Group acquired Jacksons Stores Ltd with 114 neighbourhood convenience stores located across Yorkshire and the North Midlands...and JB Beaumont Ltd in November 2004, a convenience store operator with six stores in the East Midlands....”

3.50 2006:

“We now have 297 convenience stores, trading under the brands Sainsbury’s Local, Sainsbury’s @ Bells and Sainsbury’s @ Jacksons. Last year we opened 20 stores, refurbished 34 Sainsbury’s Locals and 60 ‘Sainsbury’s @’ stores. We achieved another good year in our convenience stores and expect this part of our business to generate £400 million of the £2.5 billion of additional sales set out in our recovery plan...20 new convenience stores were opened, five of which related to the acquisition of SL Shaw Ltd...[and we achieved] 94 refurbishments and conversions of convenience stores.”

3.51 The IGD predicted that Sainsbury’s convenience store turnover will increase by two-thirds in five years even if there are no further acquisitions (this was before the purchase of SL Shaws). The report says (*ibid.* p.130):

“Sainsbury’s has stated that it intends to increase its convenience sales from just over £400m to £800m over the next three years. Part of this will be offset by Sainsbury’s broader definition of convenience retailing (IGD has excluded certain stores from this analysis) but even so, with the current portfolio, this will be a very stretching target and Sainsbury’s must surely be on the lookout for additional acquisitions if it is to meet its target.”

3.52 During our own discussions with convenience sector stakeholders, most have suggested that the supermarkets’ growth in convenience stores will continue as far as the competition authorities will allow it.

3.53 In our view it has already gone too far. The blame must fall squarely on the OFT, which has relied on a series of weak market definitions to suggest that none of the mergers cited have been caught by the “significant lessening of competition” test required by the Enterprise Act 2002.

Ownership of convenience stores by independents

3.54 The ownership of convenience stores by non-multiples is more complex, primarily because of the existence of a separate wholesaling function which is not present among the supermarket groups.

3.55 Some independent groups own retail stores only, others own wholesaling operations as well as retail shops, others operate “symbol” or franchise arrangements, and some are affiliated to buying groups.

3.56 The term “symbol” in convenience retailing denotes a relationship between a shop owner and a buying or wholesaling group in which the latter provides not only goods but also a variety of support functions – particularly branding.

3.57 In Table 6 below we rank convenience stores in the symbols and franchises category as determined by IGD.

Table 6: symbol group and franchised fascias, ranked by numbers of stores

All stores belonging to a symbol or franchise, by fascia	Number	Per cent
Spar UK	2,724	21
Londis and Budgens (Musgrave)	2,087	16
Premier (Booker)	1,900	15
Lifestyle/Scandia (Landmark)	1,440	11
Costcutter	1,400	11
Nisa (Nisa-Today's, Day Today, Today's)	1,080	8
Best In/Best One (Bestway)	920	7
Supershop, Mace, Your Store (P&H Retail)	760	6
Others	724	6
Total	13,035	100

Source: IGD

3.58 A comparison of Table 6 with Table 4 shows that symbol groups form an important segment of the convenience store sector. They account for 21 per cent of all outlets that provide convenience shopping and are the second largest single segment after the 28,000+ independent, non-affiliated stores.

3.59 The largest symbol group players are briefly described below.

- (a) SPAR is an international organisation, Dutch in origin, which has been active in the UK since 1957. It is currently the largest UK symbol operation measured by number of stores.
- (b) Musgrave is an Irish-based company which owns Londis in the UK. Londis is an entirely symbol operation. Musgrave has extensive wholesaling activities in Ireland and the UK. Because Musgrave also owns the 54 Budgens stores (which are not a symbol group operation) the name Musgrave appears in Table 5 as well as in Table 6, though we should add that Musgrave is currently divesting to franchisees the Budgen stores that it owns. In 2005, Musgrave's group revenues amounted to some €4.4 billion.
- (c) Booker, a UK-based company, has traditionally been a delivered wholesale and cash-and-carry supplier for small convenience store owners and caterers. In addition, it has for nearly 20 years operated a retail symbol group under the name Premier, which it has recently reinvigorated.
- (d) Costcutter (Costcutter Supermarkets Group Limited) is likewise a substantial, well-established symbol group operation which, according to its website, works with stores from 500 square feet (52 sq. metres) up to 5,000 square feet (520 sq. metres). Costcutter also offers the Costcutter Express opportunity, which it claims is well suited to forecourt stores of under 1,000 square feet. For its procurement activity Costcutter is a member of the Nisa-Today's buying group.

- (e) Nisa-Today's, a UK-based company located in Scunthorpe, is a buying group, wholesaler and symbol group operator, owned entirely by its members, of which there are now, according to its 2004 Report and Accounts, more than 800. Nisa-Today's claims to be the industry's largest independent buying consortium. Its own revenues amounted in 2004 to just under £1 billion.
- (f) P&H (formerly Palmer and Harvey McLane) provide buying and retailing support to independent convenience store owners. Its website lists several types and levels of support to different types and sizes of store.

The UK population of convenience stores

- 3.60 There has been an overall decline in the total number of UK convenience stores in the last six years. IGD gives a total of 55,798 as at April 2000 compared with 51,526 as at April 2006.
- 3.61 The composition of the total is complicated by a reclassification of affiliated and non-affiliated as at April 2004. Since that date, the number of non-affiliated stores has declined by 2,300, and the number of forecourt stores by just over 500. The number of symbol group stores has increased by 300 and the convenience multiples by 200.
- 3.62 As Table 5 shows, just over 1400 of the highest turnover convenience stores have been acquired by Tesco (1260) and Sainsbury (179) since January 2003.

Conclusions arising from market structure

- 3.63 It is clear that convenience stores do not form a homogeneous entity. Collectively they encompass a wide diversity of ownership, type of operation, revenue per store and revenue per square foot of store. In addition, the buying/wholesaling function for convenience stores, other than those owned by multiples, should be regarded as forming an essential part of the convenience store segment. There is a mutual dependence of convenience retailers on the wholesalers that supply them and *vice versa*. If one level in the supply chain is weakened the effect is inevitably felt in the other. These features seem to us important in the context of a competition analysis.
- 3.64 We observe a sharp dividing line in terms of average revenue between the smaller players in the sector (the non-affiliated independents and the symbol group stores) and the larger players, particularly the stores in multiple ownership. As Table 3 makes clear, the convenience multiples and those owned by Co-ops (which we suggest are effectively in the same segment) achieve average annual revenue of over £1 million per store. The Big Four supermarket multiples achieve an average of over £3 million in convenience sales per annum per store. By contrast, the non-affiliated independents and the symbol group stores achieve average revenues of £280,000 and just over £630,000 respectively.
- 3.65 The OFT has on a number of occasions said that it regards the convenience store sector as having low barriers to entry. If, as we suggest, the sector is far from homogeneous, competition analysis needs to take into account whether the barriers are low at every level

in the sector, and, if not, whether there are barriers to expansion for those players who enter at the lowest scale.

- 3.66 In the context of acquisitions by Big Four supermarket multiples of the larger independent convenience store operators, the viability of the wholesaling function needs to form part of the wider competition analysis. As the larger convenience stores drop out of the wholesale supply chain by virtue of becoming part of a supermarket supply chain, the wholesaler left behind is weakened by loss of retail volume and by the diminished buying power that the loss of volume entails.
- 3.67 Furthermore, it is, on the whole, the larger convenience stores that have been acquired by the Big Four supermarket groups, with the result that revenue loss to wholesalers is greater than the number of convenience stores might imply. The wholesaler's weakness is then visited upon the remaining retailers in his supply chain. The remaining retailers tend to be the smaller outlets, which having limited buying clout and are thus particularly afflicted by their wholesalers' weakness.
- 3.68 It may be argued that wholesalers (and indeed retailers) may offset some or all of their disadvantages by further consolidation among themselves. No doubt some economies can thereby be achieved, but it is for closer examination to determine how much, and whether such economies would be sufficient to sustain an effectively competitive convenience retailing sector. Our intuition is that they would not.
- 3.69 In relation to consolidation, there arises firstly the question of whether a tendency towards monopoly in convenience sector wholesaling is a good thing from a competition or consumer point of view – whether, in the words of the Enterprise Act 2002 there would be a significant lessening of competition. That apart, even if all independent convenience store buying were consolidated into a single entity, it would still be less in value than that of Tesco alone (at £23 billion retail equivalent *versus* roughly £30 billion) and would account for no more than 20 per cent of all grocery purchases (at £23 billion *versus* £115 billion).
- 3.70 We now examine the question of buyer power differences in more detail.

4 THE BUYER POWER AND SELLER POWER OF THE SUPERMARKETS

- 4.1 We begin by considering the different types of commercial advantages that supermarkets may have in the grocery market as broadly defined, and we then consider whether any feature, or combination of features, in that market prevents, restricts or distorts competition.
- 4.2 The issue of buyer power is considered in some detail. We analyse the distorting effect that buyer power may have on competition in the wholesale market. We go on to consider whether continued supermarket expansion in convenience retailing may undermine the viability of independent buying groups and wholesalers, such that competitive constraints on supermarket behaviour diminish.
- 4.3 We begin by considering the kinds of advantages that supermarkets have come to enjoy in the grocery market, the extent to which these are non-objectionable from the point of view of competition economics, and conversely the extent to which they may prevent, restrict or distort competition.

What commercial advantages do supermarkets have in grocery?

Economies of scale in supermarket operations

- 4.4 There may be economies of scale in procurement (both in purchase prices and other terms of trade, and in supply chain management) which place supermarkets at a competitive advantage. This is a valid source of efficiency and gives rise to cost savings which may benefit consumers to the extent that they are passed through in retail prices.
- 4.5 At the same time, economies of scale can also represent a barrier to entry or expansion, thus diminishing competitive constraints on the Big Four supermarkets. This is well illustrated by a quotation from the 2000 CC report:
- “Booth[s] said that economies of scale and other factors were now such that it was difficult for new retailers seeking to enter the market, and small established players such as itself, to keep pace.” (paragraph 2.135)
- 4.6 The competition implications of scale economies are mixed. While costs may fall, prices to consumers will not unless there are competitive constraints which bring this about.

Vertical economics of scope

- 4.7 This term refers to cost savings arising from the vertical integration of distribution and retailing within one company. The competition implications are similar to those for economies of scale: that is to say, costs may fall, but competitive constraints may fall too, with the result that not all cost savings are passed through into retail prices. In particular, the supply chains of supermarkets are effectively closed to new entrants. Hence entry

into wholesaling is likely to become harder and less attractive as independent wholesaling groups are displaced by expanding supermarkets.

4.8 In summary, the question whether economies of scale and scope give rise to competition concerns can only be answered by reference to the context. Specifically:

(a) economies of scale and scope might represent a barrier to entry, and thus might help to give a firm a dominant position. However, using scale or scope economies¹⁶ to raise efficiency would not by itself represent anti-competitive conduct, and there need be no competition concerns unless there were evidence that dominance had been abused.

(b) one effect of the acquisition of convenience store chains by leading supermarkets could be that the buying or wholesaling group to which the acquired stores previously belonged falls below minimum efficient scale. If so, the merger could lead to a substantial lessening of competition by diminishing the ability of the independent sector to compete.

(c) economies of scale and scope could, separately or together, represent a market feature which prevents or restricts competition, particularly if they act in combination with other market features. On the other hand, any consumer benefits from the pass-through of scale and scope economies would need to be taken into consideration.

Brand value

4.9 Strong brands can increase barriers to entry as consumers become less inclined to switch to new entrants. Whether or not supermarket brands are perceived as providing offsetting consumer benefits depends partly on one's view about the role that advertising and brands play in society. Some economists have argued that brands provide benefits to consumers (e.g. by providing a signal of quality); others have argued that brand strengths are harmful to consumers (e.g. if they result from manipulative advertising).¹⁷

4.10 We are aware that the British Brands Group (BBG) is likely to make representations of its own to the Commission as regards the capacity, and indeed the tendency, of some Big Four supermarket buyers to undermine the value of brands by means of "own brand" practices. Although we have not seen, and are not expecting to see, the BBG submission, we understand from informal discussions that BBG members distinguish between the requirements of some wholesalers supplying the independent trade to seek their own "own brand" supplies and the practices of supermarket buyers. The latter, we understand, involve far more comprehensive involvement in the product plans of brand owners, to a

¹⁶ We are defining economies of scale as excluding the exercise of buyer power.

¹⁷ For a comprehensive survey of the literature on the economics of advertising, see Bagwell, Kyle (2003), "The Economic Analysis of Advertising", March

point where innovation is frustrated because of the risk that it will be rendered nugatory by own brand equivalents launched at substantially the same time at lower prices.

Upstream buyer power

- 4.11 Buyer power refers to the ability of larger buyers, especially in Big Four supermarket groups, to obtain more favourable buying terms from suppliers than would be expected under competitive conditions. In particular, a large buyer may be able to exert market power by negotiating its buying prices downwards, over and above any reduction that may be justified by any economies of scale that suppliers gain from selling in bulk to a single firm. As discussed later in this chapter, our view is that buyer power has the potential to distort competition in grocery wholesaling *and* retailing and to raise barriers to entry.

Below-cost selling

- 4.12 Although below-cost selling is far from the only anti-competitive tactic that supermarkets deploy at the retail level, it is one of the most persistent. ACS has produced evidence to the OFT that some Big Four supermarket groups engage in below-cost selling when they acquire or open new stores. Although we have been able to gather only a limited amount of evidence, it unambiguously raises competition concerns. In the short-term consumers may gain from lower prices, but the risk, self-evidently, is that supermarket outlets will raise prices once rivals have been driven out of business. Our point is that this could happen (indeed happen repeatedly) at a local level even if any given supermarket has only a low share of grocery retailing at the national level.
- 4.13 The practice of below-cost selling in larger supermarket stores was discussed in the 2000 CC report:

“We found that all the main parties ... engaged in the practice of persistently selling some frequently purchased products below cost, and that this contributed to the situation in which the majority of their products were not fully exposed to competitive pressure and distorted competition in the supply of groceries. We took account of the fact that some consumers could benefit from being able to buy goods below cost, particularly low-income consumers, but at the same time that the practice damaged smaller reference stores and non-reference grocery outlets. This would in turn impact adversely on consumers, in particular the elderly and less mobile who tend to rely more on such stores. We conclude that the practice of persistent below-cost selling when conducted by ASDA, Morrison, Safeway, Sainsbury and Tesco, i.e. those parties with market power, operates against the public interest.” (paragraph 1.6(a))

Upstream buyer power

- 4.14 Our case is that Big Four supermarkets enjoy – and abuse – both buyer power and seller power. In grocery, buyer power and seller power are mutually reinforcing, in that Big Four supermarkets can exact excessive buying terms from product suppliers because they dominate the retail market, and they are able to dominate the retail market because they can exact heavy discounts and other advantageous buying terms from suppliers.

4.15 Superstores attain and exploit buyer power as a result of a number of factors. The most important among these (though not the only one) is scale, and discussions of the waterbed effect later in this document use buying scale as the key differentiator between large superstores and smaller wholesalers or retailers. The concentration of the retail market in the hands of just a few players is clearly a crucial factor promoting buying power, because suppliers have few routes to market if they are not listed by the largest retailers. However, there are other relevant factors at work.

- Vertical integration. The integrated supply chains of major multiples mean that suppliers are faced with powerful buyers able to influence unilaterally the appearance of a product in hundreds of stores. By comparison, a non-integrated supply chain allows for numerous buying decision-makers to choose to stock products at wholesale and retail level. This allows a supplier many opportunities to influence many potential buyers. Furthermore, integrated supply chains are able more easily to harvest sales data which is itself of value, and possibly a source of dependency, to suppliers. This gives a further negotiating advantage to the retailer with an integrated supply chain.
- Ability to switch. The physical nature of a superstore makes it easier for a customer to switch to a substitute brand (or to an own-brand) than to go elsewhere to purchase their favoured choice of branded goods elsewhere.
- Broad, shallow product ranges. As the number of ranges within individual product categories are cut back, so the possibility of a branded product being de-listed is more likely to be realised. Thus it is not uncommon to see (for example) two branded ranges of baked beans cut back to one branded and one supermarket own-brand¹⁸.
- This section now goes on to analyse the issue of buyer power.

4.16 This combination of factors is, ACS contends, present in the UK grocery market. Taken together, they enhance the buyer power of the major multiple retailers to a level above and beyond that accounted for by the quantities in which they buy. ACS would urge the Commission to ascertain in its discussions with both suppliers and retailers the degree to which these features are indeed present, and the impact they have on buying relationships in the market.

4.17 The relevant market for considering buyer power is, as we have argued, the wholesale supply of groceries. It is already widely accepted that the leading supermarkets are able

¹⁸ We refer the Commission to the views of BBG in relation to branding.

to exercise buyer power in relation to the purchase of groceries. The 2000 CC report on supermarkets stated that:¹⁹

“... we believe that any main party with more than an 8 per cent share of grocery purchases for resale from its stores, and accordingly all the major buyers (ASDA, Safeway, Sainsbury, Somerfield and Tesco), are, for the most part, able to control their relationships with suppliers to their own advantage, whilst the smaller multiples are not able to do so to anywhere near the same extent.” (paragraph 2.458)

4.18 The CC analysed differences in prices paid by eleven grocery retailers for suppliers' top five lines. Tesco was found to pay the lowest prices; Budgens, one of the leading convenience retailing groups, was found to pay 11% more on average at the wholesale level. For smaller businesses the differences were likely to be greater.

4.19 The results of a supplier questionnaire discussed in the 2003 Safeway report²⁰ suggest that supermarkets have increased their buying power through time:

“Although responses varied widely, the balance of the responses was that suppliers' negotiating strength with each of the main parties [ASDA, Morrison, Sainsbury and Tesco] had weakened over the last four years, especially against ASDA and Tesco.” (paragraph 6.76)

Current buying price differentials

4.20 Since the OFT consultation in 2005, we and our advisors have held a number of meetings and phone conversations with players in convenience retailing and wholesaling, in which buying terms were one of the key issues for discussion.

4.21 There was general agreement that Big Four supermarkets obtained substantially better buying prices, at least on some products. The consensus was that the largest supermarket obtained buying prices which were at least 10 per cent lower *on average* than for the majority of wholesalers supplying the independent convenience sector.

4.22 There was, however, a general view that buying terms between leading supermarkets and other players varied depending on product. For example, independent stores and supermarkets obtain generally comparable terms for newspapers and magazines because of the peculiar arrangements that apply in wholesaling. In alcohol, much the same applies because the combination of high Excise Duty and VAT squeezes the base on which wholesale and retail price differentials can be applied.

4.23 However, supermarkets were felt to enjoy a significant buying advantage in core grocery products. If the average difference across all grocery products is of the order of 10 or 11

¹⁹ *Supermarkets*, CC, October 2000, Cm 4842

²⁰ *Safeway plc and ASDA Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc*, CC, October 2003, paragraph 1.8.

per cent (and, as some suggested, rising) it follows that the differences on core grocery products could be substantially greater.

4.24 At the hearing between Commission staff and the FWD on September 8th 2006, FWD representatives suggested that the typical discount differential on core grocery products had widened substantially. Figures of between 15 per cent and 20 per cent were suggested. We cannot too strongly emphasise how important it is for the Commission to get an accurate picture of:

- how wide these differentials really are
- where they occur; and
- whether higher discounts are supported by lower costs achievable on sales to Big Four supermarkets or are achieved by buyer power.

4.25 Some large suppliers publish pricing information setting out exactly what discount is offered for different volumes. On the other hand, other suppliers are said to be much less transparent, so that in many cases independent sector buyers do not know how their buying prices compare with those obtained by Big Four supermarkets. Suppliers (rather than supermarkets) are of course key in bringing clarity here. We have seen a draft form of the questionnaire that the CC plans to send to suppliers, and although we have suggested that the questionnaire needs to be strengthened in some areas we can only support the Commission's desire to gather essential facts by this means. ACS members have for too long been reliant on leaks and anecdote.

4.26 Basic purchase price advantages are often reinforced by other price elements and non-price elements such as over-riders and advertising support. Big Four supermarkets were felt to have a particular advantage in winning advertising support, because they were better placed to assure suppliers that they would honour commitments made (e.g. in relation to the positioning of products within stores or the final retail price). Wholesalers supplying independently-owned stores are much less well-placed to make such agreements, and we acknowledge that as a fact. Again, we hope that the Commission's supplier questionnaire will clarify much that remains obscure under this heading.

4.27 Finally, we observe that there is a sharp difference in the extent of bargaining power that different types of buyer hold over suppliers during negotiation. Big Four supermarket buyers have the clout to foreclose a large part of the grocery market to a supplier by threatening to de-list. A similar threat by a buying group supplying the independent trade would have nowhere near the same effect. Here buyer power and seller power coalesce.

Distortions to wholesale competition

- 4.28 The biggest four supermarkets now account for some 70 per cent of grocery sales at retail²¹, so it is hardly surprising that, collectively (and possibly individually) they enjoy scale advantages in purchasing that rivals do not. The questions that arise for the Commission to determine, however, are:
- (a) Do their buying prices reflect *only* the scale economies they offer to suppliers? If yes, we would have to regard this as economically defensible, though whether they achieve scale by anti-competitive methods is a separate matter.
 - (b) Does their buyer power work unfairly against the interests of suppliers? In particular, do supermarkets' practices in "own branding" work unfairly against suppliers? It is for suppliers to make their own case, but the interests of ACS members are crucially affected by the interests of suppliers.
 - (c) Do the prices that supermarkets exact lead suppliers to compensate by charging prices higher than would otherwise be the case to less powerful non-supermarket buyers? Additionally or alternatively, does the price pressure that supermarkets apply lead to a lower level of entry and innovation at the supplier level than would otherwise apply? These two considerations lead us to consideration of the so-called "waterbed effect", to which we turn at paragraph 4.80.
- 4.29 It is difficult for ACS to provide comprehensive data which might confirm that these abuses are practised. The pervasive non-transparency of pricing and other terms of trade, coupled with the limited resources available to the Association itself, mean that we have to look to the CC, with its statutory powers, to obtain more comprehensive information.
- 4.30 The acquisitions by Tesco and Sainsbury of convenience retail chains (see Table 5) have had the effect of weakening the position of wholesalers supplying independent retailers.
- 4.31 Table 5 indicates that between 2003 and 2005 1,439 convenience outlets were lost by Big Four supermarket acquisition to wholesalers. The turnover of the acquired stores, pre-acquisition, was of the order of £3 billion, or about 12 per cent of total turnover through UK convenience stores. Tesco reports that it has more than doubled the pre-acquisition turnover of the 45 Adminstores, to a level about 20 per cent higher than its own expectations. This implies that its expectations were to increase turnover by between 80 and 85 per cent.
- 4.32 If this expectation applied across all the stores acquired by Tesco (even ignoring those acquired by Sainsbury) the supermarkets' collective share of turnover through

²¹ OFT, *The Grocery Market*, May 2006, paragraph 3.9.

convenience stores would amount to about 20 per cent of the turnover currently passing through convenience stores. The figure could be as high as 25 per cent, depending (a) on what Sainsbury has achieved and (b) on how far in excess of 80 to 85 per cent increase Tesco has achieved.

- 4.33 However, our principal point is that the impact on wholesalers of losing the 12 per cent or so of market share that Tesco and Sainsbury acquired, plus whatever growth the acquired stores might have achieved in independent ownership, is a serious matter not only for wholesalers but for the remaining retailers that they supply.
- 4.34 With assistance from our economic advisors, Europe Economics, we have carried out some analysis of the potential effects on wholesalers supplying the independent grocery trade and we now turn to these.
- 4.35 We have already referred (at paragraph 4.11) to the concerns of the British Brands Group, and we should like to emphasise not only that ACS supports the views of BBG but feels that the Commission should bear them in mind as evidence of buyer power which restricts and distorts competition at the supplier level.

Independent buying groups and wholesalers

- 4.36 Both ACS and FWD have voiced concern that the acquisition of convenience stores by supermarkets will undermine the viability of the buying groups and wholesalers serving the remaining convenience stores. If this is the case, then continued expansion by the supermarkets will have the effect of further weakening the competitive constraints on supermarket behaviour in the convenience retailing sector. IGD has stated that:

“For many years, convenience retailers have sought to overcome the limitations of fragmented store ownership through the development of various organisations, all intended to deliver benefits for members through buying, the support services or political influence.

With large numbers of convenience stores changing ownership, the influence of the organisations can be undermined, to the detriment of those remaining in membership.”²²

- 4.37 This reduction in viability might happen in at least two ways:
- (a) Buying groups and wholesalers may lose bargaining power with suppliers, further widening the gap between the buying prices obtained by leading supermarkets and those obtained by others in the sector;
 - (b) Buying groups and wholesalers may lose economies of scale. It seems likely that at least some of the costs of running a wholesaling operation may be fixed (e.g. certain

²² IGD (2004), *Consolidation in convenience retailing: examining the implications*, December, p.151

head office and warehouse costs), even in the long run. As these groups lose scale, such fixed costs will have to be recovered over smaller volumes with the result that prices charged in the independent sector will tend to rise.

- 4.38 In theory, these effects could create a vicious circle in which loss of volume to supermarkets raises prices in the independent sector, in turn leading to price increases and further loss of volume. Thus could lead to an accelerating decline of the independent sector along with a reduction in its ability to exert a competitive constraint on supermarkets in the convenience retailing sector.
- 4.39 Europe Economics has carried out some illustrative calculations of how these effects might work. The assumptions are mostly speculative – the purpose is simply to illustrate the concepts and highlight the need for more rigorous analysis.
- 4.40 Input assumptions are shown in Table 7 below, for a hypothetical wholesaling group with initial volumes (at retail prices) of £2 billion. The key assumptions relate to the breakdown of costs between fixed and variable components. All the purchase costs of groceries (assumed to be 75 per cent of the retail price) are treated as variable, and in the absence of any firm evidence Europe Economics used a speculative figure of 30 per cent for the proportion of other wholesaling and retailing costs which are fixed in the long run.

Table 7: input assumptions

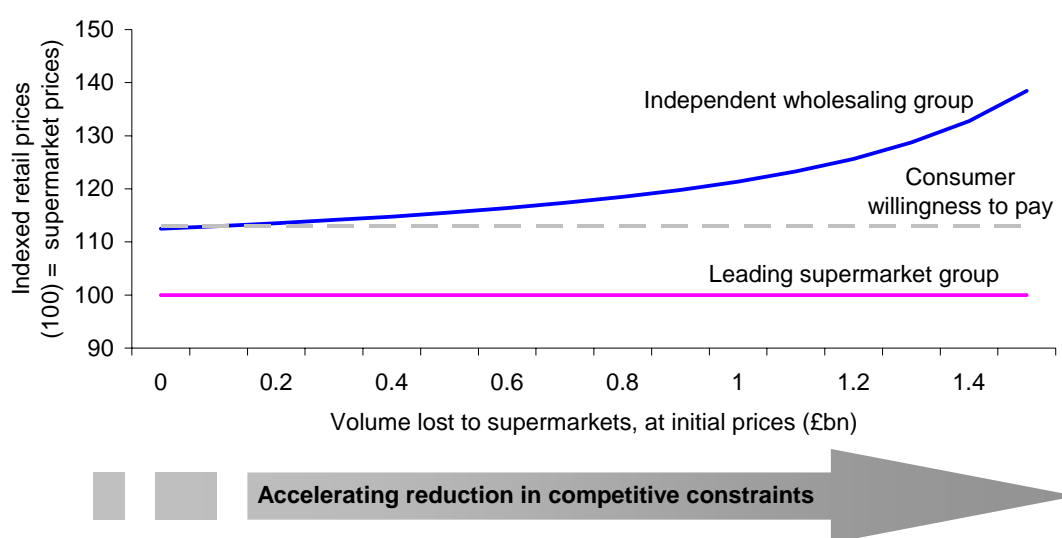
Parameter	Assumed value	Comments
Initial size of wholesaling group (£bn)	2	Hypothetical example
Initial price premium (buying disadvantage) of supermarkets (%)	12.5	IGD quotes typical figure of 10-15% FWD has suggested min. 14%
Initial breakdown of grocery retail prices (%)		
Purchase cost of grocery supplies	75	In line with figures for gross margin discussed with wholesalers
Wholesale and retailing costs (including normal profit)	25	
Change in buying prices per £1bn of buying volume (%)	0.5	The figure of 0.3% has been quoted to us for supermarkets; some contacts have suggested 0.5% for smaller groups (note 1)
Initial breakdown of wholesale and retailing costs (%)		
Fixed costs	30	Speculative figures
Variable costs	70	

Note 1: It has also been suggested that it is harder to gain an improvement in buyer power as scale increases than it is to lose buyer power as scale falls.

- 4.41 Figure 1 below shows how prices among independent retailers supplied by the wholesaling group might change as the wholesaler loses volume.

- 4.42 Market research by Harris based on shopper interviews has found that shoppers are willing to pay a premium of about 13% over supermarket prices in convenience stores²³, and this is also shown in the graph at Figure 1.
- 4.43 The results suggest that – under the speculative assumptions used – independent retailers served by the wholesaling group will pose an increasingly weak constraint on supermarket behaviour in convenience retailing as the wholesaling group loses sales and hence scale. This is particularly likely once prices in independent stores have increased beyond the level that consumers are willing to pay.

Figure 1: speculative calculations showing potential weakening of competitive constraints on supermarkets



- 4.44 The key driver of this result is loss of scale economies. This in turn is highly dependent on the proportion of costs which are assumed to be fixed, highlighting the need for further evidence to be gathered in this area. If enough reliable data could be established on buying price differentials, it would be possible to establish the point at which “tipping” occurs among wholesalers operating at different scales.
- 4.45 The reduction in bargaining power with suppliers has a much smaller effect. Intuitively this seems reasonable, since independent groups are likely to have limited bargaining power to begin with, relative to that enjoyed by supermarkets.

²³ Convenience Tracking Programme (CTP), Harris International Marketing, 2004.

Downstream seller power

Distortions to retail competition from buyer power

- 4.46 Having considered distortions that may arise from supermarket buyer power at the wholesale level, we now consider (a) whether the buyer power of supermarkets prevents, restricts or distorts competition at the retail level and (b) whether the supermarkets enjoy and exploit seller power independently of whatever buyer power they have.

Buyer power and distortions at the retail level

- 4.47 One answer is provided by an OFT research paper by Dobson *et al* on buyer power.²⁴ This paper explicitly recognises distortions to retail competition that may result from unequal buying power at the wholesale level. Section 7 of the paper discusses in some detail the nature of this distortion to competition. The relevant quotation is given in full because of its pertinence to supermarkets as they compete for convenience retailing:²⁵

“... when power is asymmetrically distributed between buyers, say due to firm size or order size differences, then there are concerns that those with greater bargaining power will be able to negotiate substantial discounts from suppliers compared to other less significant buyers. This may in turn **distort the nature of downstream (retail) competition**, where the lower costs for key buyers translates into competitive advantage over other firms when they act as sellers.

In the context of retailing, for example, a dominant firm may be able to negotiate substantial discounts on wholesale prices and then use these lower prices as a basis for exercising selling power in the retail market, where it might seek to reduce competition by acting in a predatory manner, forcing smaller retailers to withdraw from the market, allowing it [the dominant firm] to gain market share, which serves to reinforce its bargaining power and competitive advantage over other retailers. For the dominant retailer, this can represent a virtuous circle where a cost advantage can be used to increase its market share advantage which can in turn be used to gain an even larger cost advantage over rivals, etc.

But for suppliers and other retailers they are equivalently caught in a vicious circle.

For **suppliers**, once they give discounts to a dominant buyer then this is only likely to yield the buyer a greater competitive advantage in its downstream market which in turn will increase its bargaining power, forcing suppliers to give even greater discounts.

For the **other retailers**, they face the problem of a declining competitive position, being unable to negotiate the same discounts as the dominant firm, with their profitability consequently suffering and their long-term viability undermined.

²⁴ Paul Dobson, Mike Waterson and A Chu, “The Welfare Consequences of Buyer Power”, OFT Research Paper 16, 1998

²⁵ Paragraph breaks have been added to aid clarity and the emboldening is ours.

The **overall effect of this process on consumers is not certain, but they may ultimately lose out through reduced choice of retailers as well as increased prices** if the dominant retailer is able eventually to set higher prices without the prospect of weakening its stranglehold on the market.” (p.28)

“... most recent attention in regard to buyer power has focused on that in the context of retailing, not least since it is this sector which has seen such rapid consolidation (especially relative to corresponding consolidation at the supplier level) and where **evidence has emerged of a shift from supplier domination to buyer domination in the supply chain**. It is also the case that in this sector there is wide scope for a variety of buyer-induced practices, which may be potentially anticompetitive, and more general concern that the exercise of buyer power may not only distort competition at the supplier level, but also at the downstream level where **retail competition itself may be restricted and distorted.**” (p.33)

- 4.48 It is for the Commission to gather and assess evidence – which we do not have in any degree of detail, for lack of transparency in the wholesale market – connecting buyer power with seller (retailer) power. Our view is simply that the theoretical analysis propounded in the OFT paper appears consistent with what we see happening.

Seller power

- 4.49 As we have already commented, the Big Four supermarket groups together account for about 70 per cent of the UK retail market for grocery. Although dominance, whether collective or individual, is not precisely defined in UK or EU competition law, it is inconceivable to us that such a market share should not be considered dominant; or that such abuses of seller power as we see do not derive from that dominant position. The abuse we see is a breach of Chapter II of the Competition Act 1998.
- 4.50 During the OFT consultation in 2005 we assembled such evidence as we then had that Big Four supermarkets were deliberately targeting local rivals either in overall trading terms or in relation to specific product types. A year on, the evidence we have is still largely anecdotal, but we include it here in abridged form in order to give the Commission some insight into practices which concern us and which we suggest need to be explored in greater detail.

Targeting rivals – “micro-marketing”

- 4.51 We have additionally commissioned Professor Paul Dobson of Loughborough University to produce an independent appraisal of what he refers to as “micro-marketing” techniques, which enable supermarkets to target rivals not just locally (as we had argued) but in certain respects nationally too. Professor Dobson’s paper will be ready in early October and will be forwarded to the Commission without delay.
- 4.52 In round terms, Professor Dobson’s thesis is that below cost pricing and price flexing – the two principal practices on which we provided evidence to the OFT – are merely the tip of an iceberg, and that other practices include:

- determining price bands for a zone pricing policy
- local advertising
- product range and category depth
- promotions and coupons
- store layout and customer amenities
- opening hours
- store size, format and precise location

4.53 We now turn to practices to which we have already drawn the OFT's attention.

Price flexing

4.54 The OFT's document of May 2006 which announced the CC reference²⁶ has much to say on price flexing. Interestingly, and despite its powers to gather more information than we are able to do, the OFT remained disposed to think that price flexing *could* be continuing and *could* be detrimental to consumers but did not commit itself to a view.

4.55 Two quotations from the OFT's document seem to us particularly telling:

“Legitimate competition concerns and harm to consumers could nevertheless arise if price discrimination, in the form of below-cost selling or price flexing, in some areas is used:

to take advantage of an existing position of market power – for example, where prices in a location reflected lack of local competition and choice for consumers, or

in a predatory way, to force competitors out of the market and create or reinforce a position of market power.” (5.34)

“Based on the evidence of below-cost selling and price flexing, and against the background of the CC's previous findings on pricing behaviour, the OFT believes that there are reasonable grounds for suspecting that the pricing practices outlined in this chapter – below-cost selling and price flexing – are distorting competition, at least to some extent, in the supply of groceries by retailers in the UK.” (5.35)

4.56 The OFT's document cites four examples of price flexing, of which three were adduced as evidence by us during the OFT consultation. The three examples were:

²⁶ *The Grocery Market: the OFT's reasons for making a reference to the Competition Commission, May 2006*

- a discount by Tesco of (effectively) 40 per cent for purchases over £20 in Withersea, East Yorkshire, targeted at the local Proudfoot store. The scheme ran for four weeks.
 - in Belshill, near Glasgow, and in Hull, a 30 per cent effective discount by Tesco on purchases of at least £30 during may 2005
 - deep discounts by Tesco on certain brands of tea and coffee in Tesco Extra stores in Cleethorpes and Grimsby, targeted at NISA-Today's local retailers.
- 4.57 Sir Ken Morrison quoted examples of Tesco discounts £15 on purchases of at least £40 (effectively up to 37.5 per cent) on the Isle of Wight, allegedly targeted at a newly opened Morrison store.
- 4.58 Most recently we have seen discounts of up to one third (£1 against expenditure of £3 and £2 against expenditure of £6) relating to the opening of a Tesco Express store on Piccadilly, Manchester. The offer ran for two weeks, from May 15 2006 to may 28 2006.
- 4.59 The OFT accepted assurances from Big Four supermarkets that price flexing was practised only to a limited extent but published no response from Tesco to any of the four examples quoted above. To accept vague assurance as responses to specific allegations, and not to establish whether the four allegations were symptomatic of more a widespread practice seems to us wholly inadequate. It was one of the reasons why we challenged, before the Competition Appeal Tribunal, the OFT's original decision not to refer the grocery market to the Competition Commission.

Below-cost selling

- 4.60 As with price flexing, the OFT acknowledged the anecdotal evidence that ACS and others produced at the 2005 consultation but reached no firm conclusion on it.
- 4.61 In its decision document already referred to the OFT recorded that below-cost selling (which it defined as selling line items below a gross margin of 5 per cent) was still practised by Big Four supermarkets, although allegedly on only a modest scale, affecting about 3 per cent of sales value through supermarkets. We suggest that the figure of 5 per cent needs to be revisited. If 5 per cent is reckoned to be the minimum gross margin needed to cover supermarkets' overhead costs and their cost of capital it is arguably too low, and we would be interested to know how much the affected sales value increases for each 1 per cent by which the 5 per cent margin is increased.
- 4.62 The OFT rightly points out that below-cost selling does not only take place in supermarkets but also in supermarket-owned convenience stores (albeit on a smaller scale). This being so, below-cost selling distorts competition not only between supermarkets and convenience stores generally but also between supermarket-owned convenience stores and independent convenience stores. There is therefore every reason for the Commission to probe below-cost selling very thoroughly, no matter how difficult the remedies to it might be.

4.63 The capacity of a competition authority to compel the production of relevant information to a degree that we cannot possibly aspire to is amply demonstrated by the problem of below-cost selling. By exercising its statutory powers, the OFT was able to identify that 2,708 grocery lines were sold by supermarkets at a gross margin of no more than 5 per cent. In our evidence to the OFT we were able to identify, with certainty, only three:

- Easter eggs, where the effective discounts given by ASDA and Tesco were almost 50 per cent
- some alcohol (see below); and
- fuel supplied through hypermarkets (not a grocery item but taken into account because of its impact on grocery shopping). Here discounts and vouchers produced highly variable rates of effective discount, but at retail they were typically about 4p per litre below a cost range which at the time spanned 68p to 72p.

4.64 We suggest that the below-cost selling of alcohol is particularly noteworthy because alcohol is an important grocery category and retailers expect to see the heaviest sales of the year in the lead up to Christmas. It has therefore developed as a key category for aggressive price cutting. We believe that the products cited here are the most extreme example of aggressive discounting that occurs in this category during this period.

4.65 In the lead up to Christmas 2005 ASDA sold 1 litre bottles of Bells, Gordon’s, and Bacardi at 2 for £20. This equates to a selling price that is significantly lower than a wholesaler supplying the independent trade can buy the product for, as Table 8 shows.

Table 8: Bell’s whisky, Gordon’s gin, and Bacardi rum – comparison of ASDA selling price and wholesaler buying price

	ASDA selling price	Wholesaler A’s buying price	difference	
			£	%
Bells	8.51	11.53	3.02	26.2%
Gordon’s	8.51	10.34	1.83	17.7%
Bacardi	8.51	11.13	2.62	23.5%
All prices are net of VAT				

4.66 Similarly, Tesco ran a pre-Christmas promotion in its Tesco Extra store in Grimsby, pricing a 1-litre bottle of Bell’s, Gordon’s or Bacardi at £9.99, and yielding almost exactly the same numbers as in Table 8 above.

4.67 We hope that the Commission will be able to go further in exploring below-cost selling than the OFT chose to do last year.

Branding

- 4.68 We have already referred briefly to concerns about the seller power of supermarkets in relation to product branding. We acknowledge that the lead on such issues will be taken by BBG. We merely wish to record here that convenience stores are critically dependent on strong grocery brands.
- 4.69 As we understand it from BBG, supermarkets have displayed and exploited a capacity to undermine the strength of brand owners by requiring them to share confidential information concerning product innovation so that “own brand” producers can free-ride on the intellectual property of brand owners. If this practice is widespread, we would object strenuously on grounds that this is an abuse of dominance which distorts competition in two ways. It distorts competition between retailers which have substantial “own brand” presence and those which do not; and it distorts competition between suppliers.

Consumer prices

- 4.70 Although one might expect supermarkets to pass on the benefits of their superior buyer power to consumers in an effort to reinforce their seller power, we have established that, at least in pricing through its convenience stores, Tesco prefers to keep for itself a large part of the benefit. We support this statement with evidence submitted to the OFT in February of this year.
- 4.71 In early February we conducted price comparisons between Tesco, Tesco Express and One Stop Convenience Stores. One Stop is a chain bought by Tesco through its purchase of T&S Stores, which was allowed by the OFT in 2003. To be clear, Tesco owns and operates One Stop. Tesco is acquiring new One Stop sites from independents, and it cannot be termed a legacy brand awaiting sale or conversion to other formats. *Convenience Store* magazine reported in October 2005 that at that time Tesco ran 511 One Stop outlets, that conversion of One Stop stores to Tesco Express was coming to an end, and that One Stop was actively seeking expansion through acquisitions. At the end of 2005 there were 531 One Stop convenience stores.
- 4.72 To establish a basis for price comparison we first consulted the Grocer33 pricing index for the week of 14 January. Of these 33 products, 15 were deemed to be likely to be found in both Tesco Express and One Stop outlets. For the avoidance of doubt, these products were selected prior to comparing prices in stores. Secondly, we visited a One Stop store and a Tesco Express store about one mile apart in Surrey. These stores were chosen simply because of their proximity to our offices.
- 4.73 We attempted to purchase the 15 selected items, two of which were not available, to provide a comparison²⁷. One product was substituted for another²⁸ comparable item.

²⁷ Marmite 125g and Fairy Liquid 500ml were not available in both stores.

One item was not directly comparable but we instead chose the cheapest available item matching that description of the product²⁹.

4.74 Finally, we recorded the prices in each store and obtained receipts of purchase. We found that the price of these products in One Stop was 20.5% higher than prices for the same products in Tesco Express. Table 9 below gives the details.

Table 9: shopping basket price comparisons

Product	Tesco	Tesco Express	One Stop
2 pint semi-skimmed milk	0.64	0.64	0.83
415g Baked Beans	0.44	0.46	0.59
Flora 500g	0.91	0.94	1.19
Tetley tea bags 80	1.40	1.49	1.89
Weetabix x 24	1.33	1.38	1.85
Cheapest toilet roll x 2	0.82	0.85	0.99
Persil tablets x 24	2.44	2.54	2.79
Pringles Original 200g tube	1.38	1.44	1.55
Cheapest eggs x 6	0.54	0.64	0.89
Mr Kipling Jam Tarts 6-pack	1.09	1.13	1.19
Oxo cubes x 12 beef	0.69	0.72	1.05
Cadbury Chocolate Fingers 150g	1.05	1.09	1.35
Hovis sliced white bread 800g	0.88	0.88	0.95
Total	13.61	14.20	17.11
% increase between shopping baskets	Tesco	Tesco Express	One Stop
Tesco			
Tesco Express	4.3		
One Stop	25.7	20.5	

4.75 There is no branding or other indication in a One Stop store or on a receipt to suggest that the outlet is owned by Tesco. It thus appears to us that the benefits of Tesco's buyer power advantages are held back from the consumer when Tesco's brand is not in play. We also note that the One Stop format does not obviously attract heavier investment in store standards which would justify its price premium over Tesco Express.

Quality of service

4.76 In weighing up consumer benefits as an outcome of competition between different groups of players in grocery retail, we urge the Commission to take note of the large-scale surveys undertaken annually by Harris International Marketing. These surveys cover a very wide range of features in consumer attitudes, expectations and experiences.

²⁸ Mr Kipling Bramley Apple Pies 6-pack was not available in both stores, but the Mr Kipling Jam Tarts 6-pack was available and was used instead.

²⁹ Andrex toilet roll 2-pack was not available.

- 4.77 The Big Four, as we have seen, appear to believe that their own presence in the convenience store sector is a signal benefit to consumers. One extract from the Harris 2006 survey of convenience shoppers suggests otherwise.³⁰
- 4.78 The Harris spreadsheets as supplied to us enable comparisons to be made of different types of shopper frequenting different types of convenience store. For illustrative purposes we selected (in HIM's nomenclature) an "average c-shopper" and compared the average c-shopper's satisfaction ratings across five convenience store categories: Sainsbury's Local, One Stop (owned by Tesco)³¹, Independent Average, ACS direct, and Londis.
- 4.79 All three independent store types outranked both supermarket-owned store types in respect of speed of service, value for money, product availability, staff friendliness, shop cleanliness/hygiene, and overall. In relation to fresh products, Londis outranked both Sainsbury's Local and Onestop; the Independent Average scored equally with Sainsbury's Local but outranked Onestop; the ACS direct fell fractionally below Sainsbury's Local (at 7.4 versus 7.5) but outranked Onestop. For the average c-shopper the overall rating "best in class" (which is reported regardless of spreadsheet selections) were Booker Premier stores. Booker Premier stores were also best in class for value for money.

The "waterbed effect"

Buyer power and its effect on consumers

- 4.80 Thus far we have considered supermarkets' buyer power within the wholesale market for grocery. We now wish to consider how, in conjunction with seller power, its effects might work through to consumers.
- 4.81 Consumers may lose out in the long run if buyer power and seller power combined lead to a reduction in competition and allow a few firms to establish market power in the retail market. Once firms have established a dominant position, they may be in a position to:
- (a) raise prices above competitive levels to increase profitability;
 - (b) cut back on the range of products on offer or the number of retail outlets, thus increasing profitability at the expense of reduced consumer choice.
- 4.82 The question arises, however, whether consumers lose or benefit if supermarkets achieve better buying terms from their suppliers and pass these savings on in the form of lower retail prices. The answer depends partly on the nature of competition between suppliers of groceries, which we recognise may differ from one product to another.

³⁰ *Convenience Tracker Report*, Spring 2006.

³¹ Tesco Express stores were not available to us in the version supplied

- 4.83 In cases where the market for the supply of a particular grocery product is monopolistic or oligopolistic, supermarket buyer power may have the beneficial effect of reducing the ability of upstream producers to exploit market power (an effect generally referred to as “countervailing buyer power”).
- 4.84 On the other hand, for grocery products where the supply side is competitive (including markets in which there is “monopolistic competition” between suppliers of differentiated products), it seems unlikely that consumers overall will benefit from supermarket buyer power, for reasons which we explain below.
- 4.85 Economic theory suggests that in competitive markets not distorted by market failures, market outcomes will converge towards a socially-optimal “competitive equilibrium”. This equilibrium will have a number of favourable characteristics, including:
- (a) Production taking place at lowest cost;
 - (b) Prices reflecting costs, with suppliers making a normal level of profit but no more;
 - (c) Decisions about what is produced and in what quantities reflecting consumers’ preferences.
- 4.86 Economic theory also suggests that the existence of market failures – of which market power is an example – can distort markets and move them away from the optimal outcome.
- 4.87 Buyer power is simply one type of market power, and we would expect the exercise of supermarket buyer power in product markets which would otherwise have been competitive to give rise to detrimental effects.
- 4.88 In the absence of buyer power suppliers would trade in a competitive market and would be making a normal level of profit (but no more). If supermarkets force down supplier prices through the exercise of buyer power, suppliers will no longer make sufficient profit, in the long run, to justify remaining in the market. We would expect to see market adjustments until suppliers as a whole were again making a normal level of profit. At least two types of market adjustment are possible, both of which would harm the interests of consumers:
- (a) *Reduction in choice and innovation.* In order to supply to supermarkets at the prices they demand, suppliers may choose to cut back on investment in new products and in innovation generally.
 - (b) *Exit of suppliers leading to increased prices for non-supermarket buyers.* Suppliers who are no longer making sufficient profit may choose to leave the market. This reduction in supply will increase prices for other buyers who are unable to exercise market power). The process will continue until prices to non-supermarket buyers have risen sufficiently to offset the lower revenues that suppliers now earn from supermarkets and thus to restore supplier profitability. The net result is that

supermarkets achieve lower prices at the expense of other buyers paying higher prices – an outcome known as the “waterbed effect.”

4.89 In the 2003 Safeway report, the CC recognised these two potential effects:

“The consequences of uncompetitive prices [resulting from buyer power] may include ‘waterbed’ effects (where suppliers seek to recoup the lower prices they receive from large retailers through higher prices to smaller grocery retailers) or a further general weakening of some suppliers’ bargaining positions, with the result that some grocery manufacturers are likely to find investment in new products or innovative manufacturing techniques more difficult or no longer possible.” (paragraph 1.20)

4.90 However, in our view the “waterbed effect” does not require suppliers to react in a conscious way to supermarket buying power by raising prices to non-supermarket buyers in order to recover lost profits. This would imply that suppliers too had market power (necessary in order to raise prices) and that they were not previously acting in a profit-maximising way in setting prices for non-supermarket buyers – both of which would be dubious assertions.

4.91 Rather, therefore, we suggest that the “waterbed effect” manifests itself through entry and exit in an (otherwise) competitive market distorted by buyer power.³² The 2003 Safeway report concluded that, while there was little evidence of an immediate or short-term waterbed effect, this was not the case in the longer term:

“From the evidence available to us, we take the view that there may be some water-bed effect for some classes of suppliers, especially over the longer term.” (paragraph 2.248)

4.92 This is consistent with our view that the waterbed effect occurs primarily through supplier entry and exit, and then only in the longer term, rather than through the conscious pricing behaviour of suppliers in response to price reductions forced by supermarkets.

4.93 Nevertheless, there may well be price effects too, and we now consider these.

Implications of the “waterbed effect” on retail prices

4.94 Clearly, customers shopping at supermarkets gain to the extent that supermarkets pass through their better buying terms into lower retail prices. On the other hand, customers shopping at other grocery stores will lose out through higher retail prices. *On the assumption that supermarkets pass through 100 per cent of their buying discount* then overall these two effects cancel out. While there will be distributional effects, i.e. that some consumers will gain while others lose, consumers as a whole are neither better nor worse off.

³² If the market for a particular grocery product is expanding, the “waterbed effect” could occur through a reduction in the level of entry rather than through the exit of existing firms.

- 4.95 Do supermarkets pass through 100 per cent of the savings from their better buying prices? Since we do not know for certain what the buying price differentials are, or would be in a fully competitive market, it is impossible for us to say. If one takes the view that, in the long run, market power is rarely exercised in favour of the consumer, it is at least conceivable that part of the saving would not be passed through.
- 4.96 If we hypothesise that supermarkets keep back some of the savings from their better buying prices, the result is startling. Once the waterbed effect is taken into account, consumers as a whole may actually pay more. This happens because:
- (a) customers in other grocery stores pay higher prices sufficient to offset the supermarkets' better buying terms; but
 - (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.
- 4.97 Europe Economics have carried out some illustrative calculations to show the potential size of the consumer detriment under certain assumptions, which we stress are speculative. The calculations are based on a stylised version of reality, in which the four largest supermarkets have equal buying power and all other stores have none. In practice, buying power is likely to vary according to the size of the grocery retailer.
- 4.98 The input assumptions used are shown in Table 10 below. The two most important assumptions relate to:
- (a) The proportion of grocery sales for which the waterbed effect occurs. As discussed above, we suggest that a long-term waterbed effect is most likely where the supply-side of the market is competitive or monopolistically competitive, and least likely where the supply-side of the market is oligopolistic. The calculations use a speculative figure of 90 per cent for the proportion of groceries falling into the first category.
 - (b) The proportion of their lower buying price which supermarkets pass through to their customers. As discussed above, there seems no reason to believe *a priori* that all of the saving from lower buying prices will accrue to consumers. Therefore, we have used a speculative figure of 50 per cent for the proportion passed through.³³
- 4.99 The calculations assume that supermarkets extract the same discount in buying prices for all groceries, regardless of the supply side of the market. This could be a conservative assumption – supermarkets may be able to extract a larger discount where the supply side of the market is competitive (which is also where buyer power most damages consumer interests) than is possible in negotiations with oligopolistic suppliers. We have

already established with reasonable certainty (based on evidence provided by FWD) that Big Four supermarkets' implied discounts are increasing compared with where they were in 2000.

Table 10: Inputs used in calculations

Code	Parameter of calculations	Value	Notes
Downstream market			
A	Sales by biggest four supermarkets (£bn)	67	Source: OFT <i>The Grocery Market</i> , May 2006, paragraphs 3.5 and 3.9
Breakdown of grocery wholesale market			
B	Oligopoly (no waterbed effect)	10%	Speculative assumption
C	Competition or monopolistic competition (long-term waterbed effect)	90%	= 100% – B
Other parameters			
D	Wholesale price as proportion of retail price	75%	Equates to a figure of 25% for gross margin
E	Assumed buying price discount of four largest supermarkets	6%	Relative to counterfactual of no buyer power. (For goods with waterbed effect, the final buying discount <i>relative to other buyers</i> will be higher). We made no attempt to model differences in buyer power between the Big 4 supermarkets; nor to take account of variations in buying power for different types of product.
F	Proportion of discount passed through to consumers	50%	Speculative assumption

4.100 Table 8 sets out Europe Economics' calculations of consumer detriment. For the sake of transparency, we have included notes which use code letters to describe precisely what calculation was undertaken at each stage. The basic approach is to compare:

- (a) The gains made by supermarket customers from buyer power – both for products with oligopolistic supply and for products with competitive supply;
- (b) The loss suffered by consumers in other stores due to the long term waterbed effect for products with competitive supply.

³³ This is 50% of the reduction in buying price compared to the counterfactual of no buyer power. For grocery products for which a waterbed effect occurs, this equates to a lower proportion of the final discount in buying price *relative to other buyers*.

Table 11: calculations of net consumer detriment

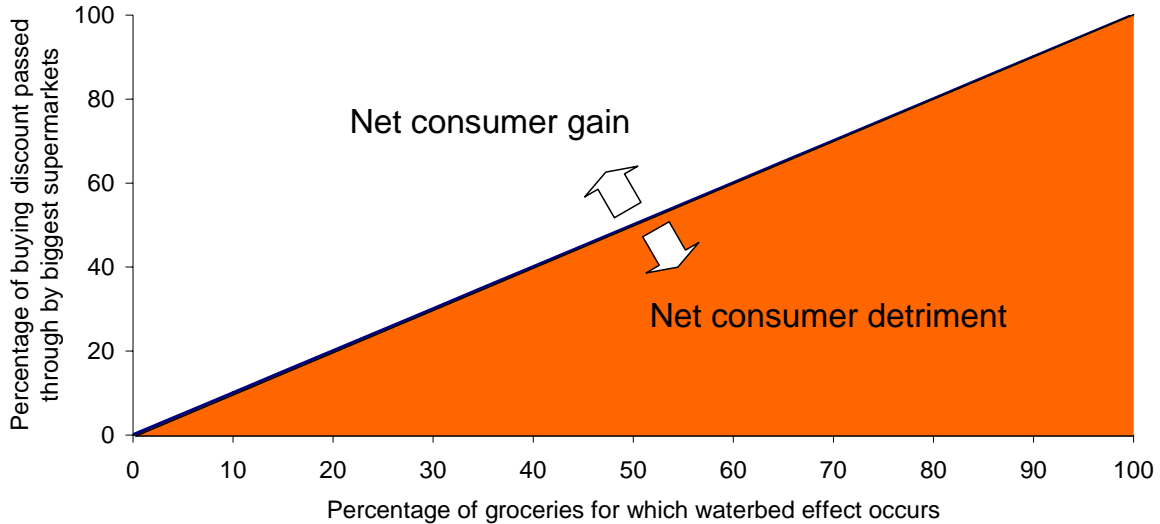
Code	Step of calculation	Amount (£bn)	Notes
Supply side - oligopoly			
G	Purchases by largest 4 supermarkets (before discount)	5.03	= A x B x D
H	Buying discount of largest 4 supermarkets	0.30	= G x E
I	Amount passed through to supermarket customers	0.15	= H x F
Supply side - competition or monopolistic competition			
J	Purchases by largest 4 supermarkets (before discount)	45.23	= A x C x D
K	Buying discount of largest 4 supermarkets	2.71	= J x E
L	Amount passed through to supermarket customers	1.36	= L x F
M	Additional amount paid by consumers in other stores due to waterbed effect	2.71	= K
N	Net gain (loss) to consumers	(1.36)	= L – M
All groceries			1.1 *
O	Net gain (loss) to consumers	(1.21)	= I + N

4.101 The results show that under these speculative assumptions, consumers could end up paying £1.2 billion more every year for their groceries as a result of supermarket buyer power. Over a period of 10 years this would give a total (discounted) consumer detriment of £10 billion.³⁴

4.102 This figure is very sensitive to the assumptions used for the proportion of groceries for which there is a waterbed effect and the proportion of the supermarkets' buying discount differential which is passed through to customers. This is illustrated in Figure 1, which shows the combinations of values for these parameters which yield a net consumer detriment.

³⁴ Discounted at the social discount rate of 3.5% recommended in HM Treasury (2003), "The Green Book: Appraisal and Evaluation in Central Government".

Figure 1: impact of assumptions on net consumer detriment



Note: The y-axis shows the percentage of the reduction in buying price – compared to the counterfactual of no buyer power – which is passed through to consumers. As noted earlier, for grocery products for which a waterbed effect occurs, this equates to a lower proportion of the final discount in buying price relative to other buyers.

4.103 Further analysis is required to determine which values for these parameters best represent reality, and hence whether there is a net consumer detriment or surplus, and of what size.

4.104 Estimating these parameters may not be easy. For instance, it might be tempting to think that the extent of pass-through to supermarket customers can be estimated by looking at whether supermarket retail prices are as low relative to other grocery stores as would be expected given supermarkets' better buying terms. However, such a comparison is likely to be distorted by other cost differences. For example, supermarkets might charge lower prices due to economies of scale while at the same time holding back a high proportion of the savings from their buying discount.

4.105 The overall message from these illustrative calculations is that the possibility of a substantial consumer detriment – of perhaps £1.2 billion per year – cannot be ruled out, but that further investigation is needed to come to a definitive conclusion.

Data needed to explore the waterbed effect

4.106 We understand that the Commission has asked FWD and/or Pareto Retail for ideas on what evidence might usefully be gathered in support of the theory of the waterbed effect, and how its magnitude might be measured. Europe Economics has assembled some ideas under this heading, and these appear at Appendix 1 to this document.

5 PLANNING ISSUES

- 5.1 We have commissioned separate work on planning issues and their relationship to competition in the grocery market. This work will be made available to the Commission during November.
- 5.2 ACS is aware of growing political pressure for a liberalisation of the planning system, in particular with reference to retail shopping space. There are good policy reasons for the existence of some form of planning system, and whatever future arrangements are put in place to guide development must respect these good policy reasons. Replacing planning with *laissez-faire* is not the answer. This is not to say that no alternative to the present framework could be imagined. But any alternative would need some system-based approach, for example to reflect local preferences and the needs of local communities in the development and maintenance of town centres.
- 5.3 Abuse or exploitation by supermarkets of current planning rules is in our view a symptom of the dominant position of supermarkets, not a cause. The planning system cannot therefore be relied on as a mechanism for countering Big Four supermarket dominance. That the current planning system cannot stand up to Big Four supermarkets is not an indictment *per se* of the planning system – it is, rather, evidence of a need for competition policy intervention. Merely liberalising in the face of supermarket dominance would allow supermarkets more fully to exploit their dominant position, not undermine it.
- 5.4 Pending the completion of our submission on planning issues, ACS members wish to draw the following points to the Commission’s attention:
- Even the possibility (usually evidenced by a planning application) of the arrival of a Big Four supermarket in a given locality has damaging effects on other local retailers. Typically these effects would include the reining back of investment, reluctance to renew leases and reluctance by banks to lend to smaller stores.
 - It is sometimes said (mainly by supermarkets) that the arrival of a major supermarket group has a regeneration effect on the locality. This generality needs to be tested. It may well be that, by virtue of their combined buyer and seller power, supermarkets drain vitality away from town centres to an extent which creates a regeneration need. They should not claim credit for solving a problem which they may have caused or aggravated in the first place. At the hearing scheduled for September 26th we should like to talk the Commission through cases affecting Stalham, in Norfolk, and Chepstow.
 - One element of the basis of competition between supermarkets and other retailers is often car parking. Consumers may like to believe that car parking at supermarkets is generally “free” but of course it is not: the costs are recovered somehow, but in ways that are generally non-transparent to users. The availability of parking is clearly a matter in which local authorities are closely involved, and it is therefore a subject to be included in the range of planning issues referred to the

Commission, but we wish to emphasise that it *is* an element of competition, not merely a planning detail that lies outside the Commission's remit.

6 POTENTIAL REMEDIES

- 6.1 At this stage we do not propose to say anything substantive about remedies, even where we are certain that detriment exists. The CC needs to establish its own conclusions on detriment before it can begin to explore remedies, and we fully recognise that we may yet receive or discover new information that causes us to think differently about both detriments and remedies.
- 6.2 It is disappointing that the CC established a number of detriments in its 2000 report on supermarkets but found it too difficult to devise remedies. We very much hope this need not happen again. We do recognise the complexity of mandating changes which will bring about fair competition in a large market dominated by a handful of large retailers and thousands of small ones, with all of whom millions of consumers enter into billions of line item transactions each year. As we have already said, we regard the present situation in UK grocery retailing as resulting from market failure. It follows that the market by itself will not produce solutions and that some form of statutory intervention will be required.

APPENDIX 1:

Gathering evidence for the waterbed effect

- A1.1 As discussed earlier, an important potential source of consumer detriment from buyer power (although by no means the only one) relates to the waterbed effect. We are currently taking forward analysis in this area, and in due course we hope to submit a separate paper on the waterbed effect to the Commission.
- A1.2 However, to assist the Commission in gathering evidence, we have given some preliminary consideration to the information which could usefully be collected to help demonstrate the existence of the waterbed effect and to estimate the scale of the resulting consumer detriment.
- A1.3 Below, we give some suggestions as to the evidence which could be gathered, under the following three headings:
- (a) Necessary conditions for the waterbed effect to be present;
 - (b) Evidence for the existence of the waterbed effect;
 - (c) Consumer detriment arising from the waterbed effect.
- A1.4 We would emphasise that our thinking on these issues is likely to develop further as our analysis proceeds, and hence these suggestions are only provisional in nature.

Necessary conditions for waterbed effect to be present

- A1.5 The waterbed effect can only exist when certain conditions (discussed below) are present. These conditions may well be present in the upstream market for the supply of some grocery products but not for others. Hence, we suggest that a starting point is to collect data which can be used to identify where these conditions exist.
- A1.6 The necessary conditions for a waterbed effect to exist in an upstream market would appear to include the following:
- (a) A significant proportion of suppliers must sell both to major supermarkets and to other grocery retailers.
 - (b) Suppliers must have a cost structure which includes an element of fixed costs, such that marginal cost is below average cost.³⁵

³⁵ One way of explaining the waterbed effect is to say that major supermarkets are using buyer power to push down their buying price towards the marginal cost of supply, which in equilibrium requires suppliers to be recouping the fixed element of their costs entirely from sales to independents.

(c) Suppliers must be charging different prices to independents and major supermarkets, with at least part of this difference being attributable to the buyer power of supermarkets (rather than to other factors such as economies of scale in supplying large volumes or the greater ability of major supermarkets to enter into promotional agreements).

A1.7 There would seem to be no inherent difficulty in collecting data on the above, perhaps by means of the supplier questionnaire.

A1.8 The mechanism which we suggest is most likely to give rise to the waterbed effect (involving the dynamics of entry and exit) requires a further condition to be in place. This is that the supply side of the upstream market needs to be “competitive”, in the sense that economic profits must tend to zero in the long run due to freedom of entry and exit.

A1.9 Assessing the extent of competition in the (upstream) supply of each type of grocery product would appear to be an intrinsically difficult exercise. For instance, a robust analysis of upstream competition would require all the various product and geographical markets relating to the (upstream) supply of grocery products to be properly defined.

A1.10 Nonetheless, any data which could be collected in this area could potentially be useful. For instance, suppliers could be asked, for each of their product areas, how many firms they regard as competitors and how intense they perceive competition to be (using a pre-defined scale to standardise responses).

A1.11 If there is a strong theoretical basis for thinking a waterbed effect will occur where these conditions are present,³⁶ then demonstrating the existence of these conditions would itself provide evidence in favour of a waterbed effect. Notwithstanding, the next section goes further and suggests ways in which empirical evidence might be gathered to demonstrate that the waterbed effect was actually occurring.

Evidence for the existence of the waterbed effect

A1.12 One way of collecting evidence on the waterbed effect is to ask suppliers directly how they respond when major supermarkets use buyer power to negotiate reductions to buying prices. Firms could respond in a variety of ways, such as reducing investment in new production capacity, withdrawing from the market, or trying to increase prices charged to other buyers.

A1.13 While we think that such evidence is worth gathering, we note that asking direct questions in this way may not identify a waterbed effect, even where it exists. This is because, as discussed earlier, the mechanism which we believe is most likely to give rise to the waterbed effect does not require suppliers consciously to raise prices to non-supermarket

³⁶ The theoretical foundations of the waterbed effect will be examined in more detail in the paper on the waterbed effect which we plan to submit separately to the Commission.

buyers in order to recover profits. Rather, we suggest that the waterbed effect is most likely to occur as a result of the long-run dynamics of entry and exit.

A1.14 It may, however, be possible to infer the existence of a waterbed effect from analysis of market data. While our thinking in this area is at an early stage, questions which may be relevant include:

- (a) Is there any evidence that buying price differences are higher in product areas where the conditions for a waterbed effect exist, relative to buying price differences in sectors where they do not?
- (b) Is there any evidence that suppliers make higher *gross* margins on wholesale supplies to independents in those product areas where the conditions for a waterbed effect exist, relative to *gross* margins in product areas where they do not?³⁷

A1.15 It may also be worth considering whether there is any international evidence which could usefully inform the debate. For instance:

- (a) Could mergers of large retailers in other countries be used to analyse how prices to other buyers changed in subsequent years as a result of the greater buyer power of the merged entity?
- (b) Can a suitable comparator country be identified in which there is no grocery retailer with buyer power? If so, is there any evidence that the price at which grocery products are supplied to independents in the UK compares most unfavourably with prices in this comparator country in those sectors where the conditions for a waterbed effect exist?

Consumer detriment arising from the waterbed effect

A1.16 As discussed earlier, the waterbed effect is one mechanism whereby the exercise of buyer power by supermarkets could give rise to substantial consumer detriment. In order to estimate consumer detriment from the waterbed effect, information is needed (among other things) on the proportion of their lower buying price which supermarkets pass through to their customers.

A1.17 As discussed earlier, a priori we would expect only part of supermarkets' lower buying prices to be passed to customers. This is because major supermarkets with significantly better buying terms than other players would be able to undercut other retailers while still retaining some of the savings as higher profits.

³⁷ The argument would be that, where a waterbed effect exists, higher gross margins to independents are required in equilibrium to allow suppliers to recover fixed costs which are no longer being recovered from sales to major supermarkets (due to the exercise of buyer power). Hence, it would be important to look at *gross* rather than *net* margins.

- A1.18 To provide empirical evidence in this area, we suggest that the Commission needs to gather data – preferably at the level of specific products – on differences between independents and major supermarkets in both buying prices and retail prices. If the *absolute value* of the difference in retail prices were less than the difference in buying prices, then this would provide *prima facie* evidence that major supermarkets were not passing through all of their buying price advantage.
- A1.19 However, supermarkets may have other cost advantages (e.g. arising from economies of scale or scope), and hence even if retail price differences were as large as buying price differences this would not necessarily mean all the discount in buying prices was being passed through. Hence, it would be useful to have data on the typical cost base for independents and major supermarkets, to allow this to be factored into the comparison.
- A1.20 High profitability in the supermarket sector could also indicate that not all of the discount in buying prices was being passed through to consumers, although it is likely to be difficult to isolate that element of profitability which arises from buyer power.