

Below-cost selling

1. This appendix reviews the extent and nature of below-cost selling by UK grocery retailers, focusing on the period between January 2005 and June 2006 as well as looking specifically at below-cost sales of alcohol in the period of the 2006 FIFA World Cup (the World Cup). Annex 1 to this appendix discusses, in more detail, how the grocery retailers measure profitability and some of the measurement issues arising in our analysis of below-cost selling.
2. Below-cost selling is where a retailer sells an item to consumers for less than the input cost. For the purposes of our analysis, we have defined a product as being sold below cost if it has a negative gross margin. We calculated gross margin as cash at the till less cost of goods and any adjustment for VAT (where required), and adding back any markdowns (eg goods close to sell by date) and some types of promotional funding (eg multi-buys).
3. Nine grocery retailers (Aldi, Asda, Lidl, Morrisons, Netto, Sainsbury's, Somerfield, Tesco and Waitrose) told us that they engaged in below-cost selling to varying extents. For each of these parties, revenue from goods sold below cost represented, for the period between January 2005 and June 2006, up to 3 per cent of total revenue.¹ Five grocery retailers (Booths, CGL, Costcutter, Iceland and M&S) told us that, in the normal course of business, they did not sell either grocery or non-grocery products at a price lower than the price charged by the supplier.
4. The grocery retailers that sell products below cost provided a number of reasons for engaging in this activity. These included the following:

¹Products that had been de-listed, reduced to clear or which the party no longer intended to stock were not included.

- (a) Certain products may be priced below cost because the grocery retailer did not want to be beaten on price, either because of a price pledge or because it wished to maintain a certain price differential with other grocery retailers.
 - (b) Grocery retailers did not want to sell their 'cheapest on display' products for more than their competitors.
 - (c) Grocery retailers might use some products as loss leaders to tempt customers into the store at certain times of the year, such as Christmas, or for events such as the World Cup.
 - (d) Some seasonal products such as fresh fruit might be sold below cost at times when grocery retailers had more stock than was necessary to meet customer requirements.
 - (e) On occasion, increases in costs from changes in supplier or supply chain logistics were not immediately reflected in the sales price.
 - (f) Grocery retailers sometimes supported the launch of a new product by selling it below cost.
5. A summary of the sales value of below-cost selling by grocery retailers is set out by product group in Table 1. Product groups that make up two-thirds, or more, of each grocery retailer's below-cost sales, by value, are highlighted in bold. This shows the concentration of below-cost selling by respondent and within this the product groups with the highest levels of below-cost selling.²
6. Table 1 shows that the majority of below-cost sales for each retailer, by sales value, are in two or three product groups. The main product groups in which below-cost selling takes place are alcohol, fresh meat, fish and poultry, and grocery (predominantly tinned and packet foods). However, a number of grocery retailers told

²There is not an exact matching of items in each group, across all parties, due to some differences in how products are categorized. The percentages in Table 1 are based on total sales value of goods sold below-cost. The percentages do not reflect how much of a total product group is sold below cost.

us that there were fundamental issues with cost allocation in the categories of fresh meat, and fish and poultry. As a result, the extent of below-cost selling in these products that is shown in Table 1 may be overstated.

7. Other product groups in which items are sold below cost include CDs, DVDs, books, non-alcoholic beverages, confectionery and health and beauty products. [X] and [X], in particular, sell a significant number of products below cost in the CDs, DVDs and books category, but this is not a feature for the other grocery retailers.

TABLE 1 Summary of percentage of below-cost selling by product group for main respondents

Product group	per cent							No of retailers*
	Asda	Morrisons	Sainsbury's	Tesco	Aldi	Somerfield	Waitrose	
Alcohol								6/7
Bakery†								2/7
CDs/DVDs/books								1/7
Chilled convenience								
Clothing								
Confectionery								4/7
Dairy								7/7
Electronics								
Floral/flowers								
Food to go								
Fresh meat, fish and poultry								2/7
Frozen								
Dry grocery								
Health and beauty‡								
Homewares and toys								
Household and petcare								
Newspapers								
Non-alcoholic beverages								
Pharmacy								
Produce								
Stationery								
Tobacco								
Total	100	100	100	100	100	100	100	
No of significant categories	3	3	5	4	2	3	2	
Percentage of below-cost sales represented by these categories (%)	76	65	66	72	82	67	71	

Source: CC analysis of main party questionnaire.

*This column shows the number of retailers who have that product group as one of their principal below-cost selling categories.

†Includes in-store bakery. [X] has expressed an issue with cost reliability with this product group.

‡Babycare included within Health and beauty.

Note: '0' indicates there are sales in the category but the percentage is less than 0.5 per cent.

8. Table 2 shows the percentage of below-cost sales for the largest grocery retailers that engage in below-cost selling by own-label and branded products. This shows that:

- (a) for [redacted] approximately half of its below-cost sales, by value, are branded products and half are own-label products;
- (b) for [redacted] and [redacted] the majority of their below-cost selling is in branded goods; and
- (c) for [redacted] Tesco and [redacted]³ the majority of products sold below cost are own label.

TABLE 2 **Below-cost selling, branded and own-label products**

	Branded products		Own-label products	
	£'000	%	£'000	%
Asda*				
Morrisons				
Sainsbury's				
Tesco				
Aldi				
Somerfield				
Waitrose				

Source: CC analysis of data provided by grocery retailers.

*In addition, there is £[redacted] of sales which we were unable to allocate between the branded and own-label categories.

9. Within own-label below-cost selling there appears to be a high proportion of value products. Sainsbury's 'Basic' range represents [redacted] per cent of own-label below-cost sales with a value of £[redacted] million. Tesco's 'Value' range represented [redacted] per cent of own-label below-cost sales with a value of £[redacted] million. Morrisons' 'Bettabuy' range represented [redacted] per cent of own-label below-cost sales with a value of £[redacted] million.
10. Table 3 shows the losses incurred as a result of below-cost selling divided between branded and own-label products for each grocery retailer.⁴ This indicates that, on average, products sold below cost were sold at 11.9 per cent below their cost price.

³[redacted]

⁴The percentage loss has been calculated as total revenue per product minus total cost per product divided by total cost per product. The calculation uses a total sales value provided by the parties, which has usually been taken direct from till/EPOS data, and a CC generated cost of sales, calculated from data (supplied by the parties) on cost per product item multiplied by the volume of sales for that product.

TABLE 3 Percentage loss by brand/own label for each party

	<i>Branded</i>	<i>Own label</i>	<i>Overall</i>
Asda	([X])
Morrison			
Sainsbury			
Tesco			
Aldi			
Somerfield			
Waitrose			
Unweighted average			

Source: CC analysis.

[X]

11. Table 4 shows the average period when a product (or SKU) was sold below cost. This shows that own-label products tend to be sold below cost for longer periods than branded products.

TABLE 4 Average offer periods*

	<i>Branded</i>	<i>Own label</i>	<i>Overall</i>
	<i>weeks</i>		
Asda	([X])
Morrisons			
Sainsbury's			
Tesco			
Aldi			
Somerfield			
Waitrose			
Unweighted average			

Source: CC analysis.

*The table uses average offer periods, which take account of coterminous offer periods, eg when a product is sold below cost for two different periods with less than a week in between the offers it has been classed as one period.

[X]

Below-cost selling of alcohol during the World Cup in 2006

12. As part of our assessment, we have looked specifically at the extent of below-cost selling of alcohol during the football World Cup in 2006, as it was put to us that this was an intense period of such retailer activity.
13. Table 5 sets out the number of SKUs, volume and sales value of alcohol products sold below cost during the World Cup for five grocery retailers. Total sales value of

below-cost alcohol sales during the World Cup by the five grocery retailers was approximately £38.6 million.

TABLE 5 World Cup below-cost selling of alcohol, including beer, wine and spirits

Grocery retailer	No of SKUs	Volume '000	Sales value £'000
Asda	5	1,840	12,915
Morrisons	2	75	705
Sainsbury's	29	1,417	7,167
Somerfield	3	277	2,602
Tesco	10	2,148	15,200
Total	36	5,757	38,589

Source: Various grocery retailers.

14. Tesco told us that key seasonal periods, such as the summer period between the May bank holiday and July, were a period of intense competition among retailers for the sale of alcoholic products. For larger retailers, this is particularly true with respect to alcohol multi-pack offers. Tesco said that the World Cup in 2006 happened to coincide with this intense period of competition and, as a result, the majority of point of sale advertising in store at this time was focused on the World Cup. Similarly, many of the manufacturers of alcoholic products had World-Cup-related promotions on their packaging.

15. On average, below-cost alcohol sales by value were three times more, per week, during the World Cup period than in the period January 2005 to June 2006, although a similar number of SKUs were being sold below cost in both periods. This shows that during this period of heavy promotion there was no increase in the number of products sold below cost, although there was an increase in sales.

Profitability measures and their effect on the analysis of below-cost selling

1. This annex sets out the factors which affect the measurement of below-cost selling. The main profitability measures used by the largest grocery multiples are departmental/product category profitability, and store/branch level profitability. Individual product level profitability is not generally a measure used by the parties in their day-to-day analysis of their business.
2. Two grocery retailers ([redacted] and [redacted]) calculate individual product profitability. However, [redacted], for example, uses this product profitability measure to assess the performance of its commercial teams, which are responsible for buying and pricing products and specifically not to calculate and assess individual product gross margins. Another grocery retailer, [redacted], uses product profitability as an 'exceptions' reporting mechanism. That is, it is calculated to investigate trends on an ad-hoc basis or to review large fluctuations in margin. [redacted] does not reconcile these figures to the accounts or monitor them on a regular basis. As a result, the measures provided in their responses to our questions on this subject may be less accurate than might usually be expected from more standardized accounting data.
3. Direct overhead or shared costs (eg distribution and labour costs) are not allocated to individual products. In addition, supplier support payments such as volume discounts, advertising support and business development payments are not allocated to individual products. These costs and payments are allocated at a category level. Further, the value of any support payments is captured at the point when the payment is received rather than during the period of any promotion, and as a result, there are additional timing issues with allocating these payments.

4. Promotional support is a significant issue in calculating below-cost selling. The 2000 investigation adopted the assumption that if a product was being sold below cost on a gross margin level, it was definitely being sold below cost on a net level. It was considered that promotional support had little effect on this assumption. In the previous investigation the majority of unknown elements had a negative effect on margins, which were not thought to be outweighed by promotional income from suppliers. This *de minimis* approach allowed the adoption of the gross and net margin assumptions. However, we note that if promotional income on a particular product or group of products is significant, this will lead to the figures presented in our analysis potentially being overstated as it could move products from a perceived negative gross margin to a positive net margin.