

7 Pricing

Contents

	<i>Page</i>
Introduction	106
Price trends: evidence	107
Relative prices: evidence	109
Summary of pricing policies	110
Overall pricing strategies	110
Price bands and benchmarking surveys	111
Price focusing	112
The extent of market-led pricing	113
Group 1	113
Group 2	113
Group 3	113
Group 4	114
Summary	115
Other influences on price	115
EDLP strategies	115
Northern Ireland	115
Pricing tactics	116
Promotions	116
Types of promotion	116
Concerns about promotions	118
Loyalty cards	119
Background	119
Issues	120
Switching costs	120
The cost of loyalty cards	121
Price transparency	121
Price matching and price wars	121
Local pricing	124
Introduction	124
Company policies	124
Extent of price flexing	125
Concerns on price flexing	127
Models of price setting	127
Isochrone analysis of local price competition	127
Local competition and consumer choice	129
Results	130
Party comments	130
Below-cost selling	131
Introduction	131
Company policies	131
Concerns on below-cost selling	132
Evidence on effects of below-cost selling	133
Price leadership	135
Introduction	135
Application to the UK grocery sector	135
Asymmetry in price leadership	137

Price and cost changes, evidence of barometric price leadership.....	137
Company responses.....	137
Own-label pricing issues.....	138
Prices and margins.....	138
Issues on pricing.....	139
Transmission of supplier prices to retail prices.....	140
Introduction.....	140
Data.....	141
Results.....	141
Price competition overall.....	142

Introduction

7.1. This chapter considers the pricing policies and practices of the multiples. Chapter 4 defined the reference market and the relevant economic market, and the relevant players within it. On this basis we consider how prices are determined, and what issues arise from this.

7.2. The chapter begins by highlighting the features of pricing that distinguish this industry from others. Paragraphs 7.7 to 7.12 consider evidence on the movement in average real prices for reference products. Paragraphs 7.13 to 7.20 consider evidence on the relative price levels of different supermarket chains, although it is noted that price is only one of several value-for-money features on which they compete. Paragraphs 7.21 to 7.52 provide a summary of pricing policies and practices observed in the market, drawing on evidence presented by the parties on their own policies. The particular policies of individual operators are summarized in Appendix 7.1. We consider and review this evidence. In paragraphs 7.53 to 7.55 we consider a critique of EDLP strategies, and whether different pricing behaviour is displayed in Northern Ireland. The rest of the chapter analyses eight issues that emerged as being of particular interest. These are:

- (a) promotions (paragraphs 7.57 to 7.78);
- (b) loyalty cards (paragraphs 7.79 to 7.96);
- (c) price matching and price wars (paragraphs 7.97 to 7.112);
- (d) local price flexing (paragraphs 7.113 to 7.152);
- (e) below-cost selling (paragraphs 7.153 to 7.178);
- (f) price leadership and following (paragraphs 7.179 to 7.203);
- (g) own-label pricing issues (paragraphs 7.204 to 7.214); and
- (h) the transmission of supplier prices to retail prices (paragraphs 7.215 to 7.227).

7.3. Finally, the chapter draws together the evidence, including a characterization of how price competition may occur in this industry.

7.4. There are a number of features of multiple grocery retailers' pricing which complicate any analysis. First, we are primarily concerned with one-stop shopping, where the customer buys a large number of products at one store in one trip. However, prices are charged for individual products. There is therefore a question as to whether the focus of interest should be the individual products or a basket of products, and what products the latter comprises. It may be that the customer does not consider, or cannot recall, the prices of individual products. Some customers may focus on the price of their trolley or basket of goods. As such, this may create a situation where customers' ability to exercise choice on the basis of price for individual products may be diminished, although they may be sensitive to the cost of their typical shopping basket, and consumers may also be sensitive to the prices of a few certain 'key

value' lines. Multiples will also have to consider how they set prices over the very wide range of product lines that they sell.

7.5. Second, price comparisons between multiples are not straightforward. Where they are selling branded products, clear like-for-like comparisons between multiples can be made. However, where brands differ or own-label products are used, there may also be quality differences between products at different multiples. Additionally, there are many other aspects to a supermarket's 'offer' apart from price and product quality, for example supplementary amenities, service, length of checkout queues, range of products stocked, opening hours, parking and so on. Actual prices paid are also complicated by the widespread use of many different promotional strategies.

7.6. There are trade-offs to be made between prices charged and these non-price elements, each of which will normally raise multiples' costs. This needs to be kept in mind when examining the parties' pricing behaviour, or making comparisons of headline prices between them.

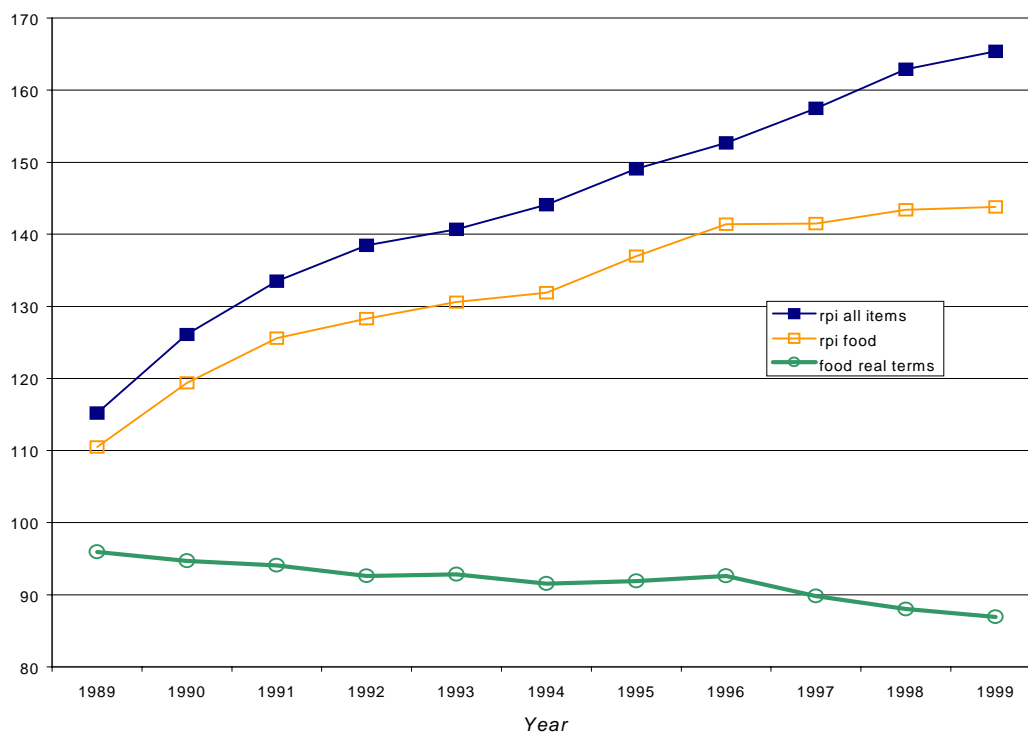
Price trends: evidence

7.7. This section considers how overall prices for groceries have developed in real terms. Reference goods are covered under several classifications in official price indices. While these product price indices are applicable to all retailers of these products, given the importance of multiples in the national retailing structure for groceries, it is unlikely that these statistics are greatly different from those that would be found purely for reference stores.

7.8. A series of the food section of the RPI is shown in Figure 7.1. While food is only one part of the reference market, it is the largest component, and there is no groceries category within the RPI that will allow a complete coverage of the reference market. The series indicate that although food prices have risen in every year from 1989 to 1999, the overall rise in prices has been less than the rise in the all items RPI, and this has also applied in most individual years. In real terms, therefore, we see a decline in the real price of food from 1989 to 1999 of 9.4 per cent, despite a small increase of 1.2 per cent from 1994 to 1996.

FIGURE 7.1

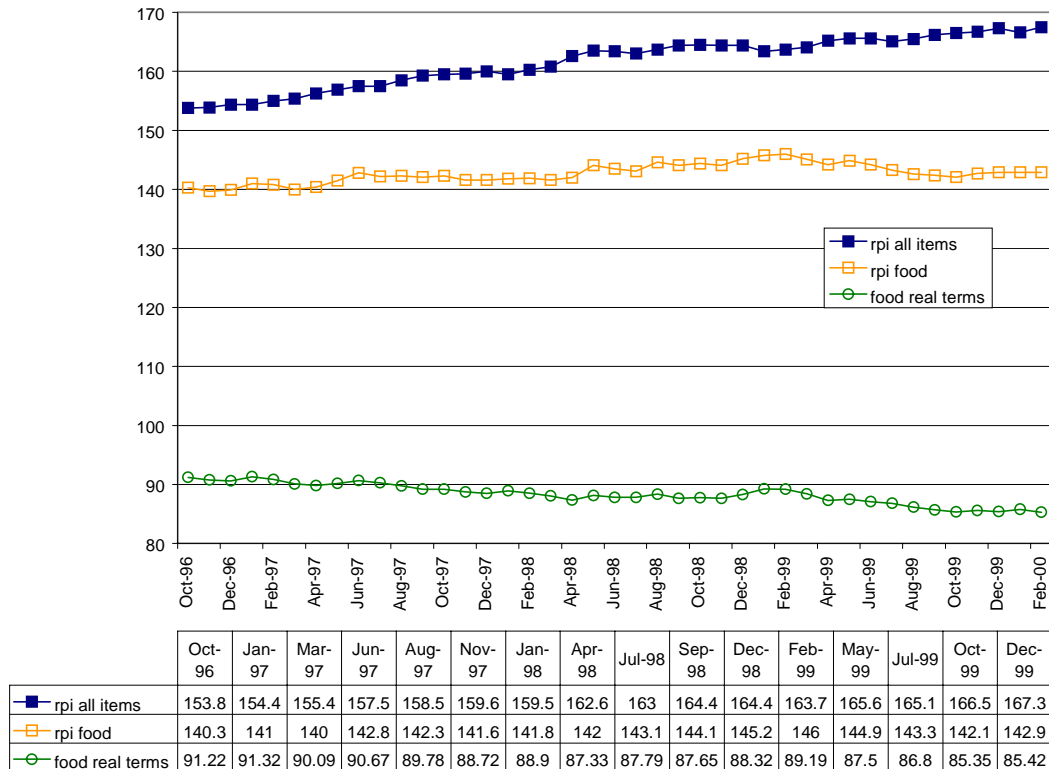
Food: real price indices, 1989 to 1999 (and RPI; Jan 1987 = 100)



7.9. We also considered recent price movements on a month by month basis. Price movements are plotted in Figure 7.2. The absolute value of the index rose to 146.0 in January 1999, before falling back to 142.1 by October 1999, and then rising slightly to 142.9 by February 2000 (85.3 relative to the overall RPI). This is largely due to seasonal price fluctuations although non-seasonal prices also fell in absolute terms in the third quarter of 1999. One causal factor is the appreciation of sterling during this period, which will have led to a decline in the price of imported supplies priced in foreign currencies.

FIGURE 7.2

Food: real price indices, 1996 to 2000 (and RPI; Jan 1987 = 100)



Source: ONS Economy Consumer Price Indices, MM23, October 1999.

7.10. Prices for the RPI are collected by field workers surveying particular products. The RPI includes coverage of all food retail outlets, and therefore products are chosen which are available in a wide range of shops. They are also chosen to reflect purchases of a typical consumer, not to be representative of all consumers. Consequently, the RPI will tend to focus on a range of frequently purchased products and does not attempt to ensure that background lines (ie low-selling lines, which are either bought infrequently, or only by a small proportion of customers) are recorded in the official statistics. Consequently, if background lines display different pricing behaviour to frequently purchased lines, the RPI may not reflect this.

7.11. The parties also put to us that prices had fallen in real terms. Tesco provided evidence to show that its prices over all its products fell by 6 per cent relative to the RPI between 1996 and 1999.¹ Asda provided evidence from OECD statistics to show that prices had fallen in the UK faster than in some other European countries.²

7.12. While this shows that prices of grocery products have fallen in real terms, this does not indicate whether price levels are reasonable, and information is not provided on non-food products or

¹Its method was to compare the prices each year for all products on sale in adjacent years, to construct a chain-linked index.
²Asda quoted OECD figures showing a comparison of changes in real food prices in Europe in 1997 to 1999. Real prices fell by 3 per cent in Italy, 2.8 per cent in the UK, 2.6 per cent in Spain and 2.4 per cent in Germany, and real prices rose by 0.3 per cent in France.

low-selling or background lines in the RPI and OECD figures. One possible reason for a fall in real prices is exchange rate effects, which are discussed in paragraph 9.111.

Relative prices: evidence

7.13. This section considers the relative prices of different UK supermarket chains. For reasons given in paragraphs 5.18 to 5.23, we concentrate on the major parties, plus Somerfield/Kwik Save. However, there are a number of problems in comparative price measures, as alluded to above. There are difficulties of interpretation when product quality may not be consistent between chains. Pro-rata adjustments to package sizes to ensure comparability are only appropriate over small discrepancies. Promotions through which prices of some products will be temporarily reduced are widespread, and a significant proportion of sales are of promoted products. It is therefore arguable that promotions should not be excluded from comparisons. For an aggregate price position, the prices need to be summed in some way to form a meaningful average or index. This could be on a sales-weighted basis, or an unweighted simple sum.

7.14. Because of the difficulties of comparability and the expense of price comparisons, no organization attempts to undertake a complete price survey of UK supermarket operators. Instead they sample a number of products, usually taken from the highest-selling lines and possibly to reflect the major products from otherwise unrepresented product sectors. Differences in product selection may result in difficulties of comparability between different surveys.

7.15. We obtained from Asda a series produced independently by TNS, based on consumer purchase data. A panel of consumers record data on the prices and quantities of all their household purchases. From this, average price levels can be inferred by dividing total expenditure by quantity purchased for each product category. However, such a methodology makes no allowance for the possibility that product quality will differ between retailers. High-quality luxury goods are not differentiated from budget goods in determination of quantity purchased. Therefore if customers of one retailer purchase a high proportion of premium products, it may appear to be more expensive than a retailer where customers are buying budget brands, even if the prices of each of these are the same between the two retailers.

7.16. The TNS data suggested that Asda prices fell from around 96 per cent of the average price of all stores at the beginning of 1994 to near 90 per cent by the end of 1998. Tesco prices in the same period varied between 100 and 103 per cent, but by the end of 1998 were nearing their lowest figure of 99 per cent. Sainsbury's figures had increased from 99 to 106 per cent over the period, while Safeway had fallen from 108 to oscillate in the 104 to 105 range. However, there may be significant biases induced by the differing value of products bought, and so it is doubtful that these figures offer an accurate representation of relative price differences. Asda disputed this assertion on the grounds that branded products (which accounted for the majority of supermarket sales) would be identical between retailers, and that own-brand products, apart from premium ranges, were also similar in terms of range and quality. Consequently it argued that as the overall retail offer was broadly the same, the figures provided a useful comparison of relative price differences. However, the typical mix of qualities bought by consumers might vary. Sainsbury said that any such analysis was highly misleading, as it took no account of quality differences, or any other differences in the offer between multiples, when such differentiation was a major competitive tool and non-price factors were highly valued by consumers. It also objected that this evidence was presented to it too late in the inquiry for it to be able to respond properly to it.

7.17. We considered the price baskets produced by the companies for their own monitoring purposes. These were based on a survey of a limited number of products, usually biased towards KVIs (see Glossary) or high-selling lines. The baskets were aggregated using sales weightings. However, each company chooses product lines that reflect its own sales figures and then uses these to weight their basket. Consequently comparisons are not strictly like-for-like when different companies' indices are compared. Hypothetically, each of two companies could validly claim to be cheaper than the other, if each was based on baskets of the products that its own customers buy: for example, if purchasing patterns differ between them, and pricing is lower on their relatively high-selling lines. There could also be other deliberate or accidental biases.¹ This effect was clearly seen when we pooled all the evidence;

¹For example, in how products not stocked in some stores are treated.

each company considered its own price position to be more favourable than its competitors' perceptions of its pricing.

7.18. Sainsbury presented the results of three different baskets, the first calculated without any allowance for promotions, the second making partial allowance (in so far as these were directly reflected in reduced prices), and the third making full allowance for all promotions. The basket results varied considerably and could affect relative price rankings. Including promotions tended to reduce the dispersion of prices between multiples.

7.19. Price indices of the largest multiples, produced by the largest multiples, are reviewed in Appendix 7.2. The general picture that emerges from these exercises is that for the period to the end of 1999, the prices¹ of the largest multiples can be divided into three groups. Kwik Save and Asda have the lowest prices with Morrison close behind. Secondly, Tesco prices have fallen such that it is approaching the first group, although according to Tesco its pricing is now at or below Asda's. Thirdly, Safeway, Sainsbury and Somerfield define a separate, higher-priced group, although Safeway told us that it had embarked on a new strategy since early 2000, which might affect this picture.

7.20. The information on price trends (covered in paragraphs 7.7 to 7.12), and on relative prices between multiples (paragraphs 7.13 to 7.19), is based on average price levels. While average prices are suitable for exploring trends, costs relative to income, and international or other price comparisons, consumers need not pay these prices if they are particularly price sensitive. Certain store formats (such as the discount chains) tend to offer a limited number of product lines in a basic shopping environment, often at prices substantially below the market average. Some of the major broad-range retailers have introduced budget own-label brands, designed to compete against the discounters at a similar low price. Additionally, it has been pointed out that shoppers, willing to search out promotional offers, can obtain products at substantial discounts. Therefore, it may be that many shoppers who wished to do so could obtain much of their shopping at prices below the market average. It could be argued that average prices are higher than they might otherwise be because consumers value a particular mix of goods and services rather than seeking the lowest price. Evidence gathered on UK prices for our international price comparisons exercise (see Chapter 9) indicates considerable price variability even on branded lines. The percentage standard deviation on the sales-weighted price of an identical branded line could be over 20 per cent.

Summary of pricing policies

Overall pricing strategies

7.21. The main parties' pricing policies are described in detail in Appendix 7.1. This section draws out the common themes that characterize their pricing policies and practices, which will differ in detail between particular multiples. We distinguish between: (1) companies primarily pursuing lower prices, either in conjunction with promotions or in a so-called EDLP strategy; (2) a conventional pricing strategy more reliant upon promotions, where typically price setting is more geared to reacting to competitors; (3) the limited range, low-price offer of the discounters; and (4) a group of retailers less influenced by competitor pricing. The following is a description of current practices, as the companies presented them to us.

7.22. Nearly all the parties stated that their pricing behaviour was market led. They argued that the market was so competitive that it was impossible to set prices out of line, as this would be immediately apparent to customers. They stressed that the great majority of customers regularly shopped at more than one chain and so were easily able to compare prices. Price differentials could only be justified, they believed, where there was a perceived difference in some other aspect of their offer.

7.23. None of the respondents acknowledged the existence of pricing formulas or rigid margin guides. Some parties did not even name cost factors as an influence on pricing, and solely referred to having to take account of their price position in the market place. It appeared that many companies had

¹Prices are not adjusted downwards to take account of promotions (except for Sainsbury and Asda) and loyalty card discounts, which can be significant.

margin expectations for particular product areas, although in many cases these expectations were formed on the basis of historical experience of what the market would support. Gross margins (out of which all operating costs must be met) will vary for a number of reasons, such as the velocity of sales, the costs of storage, transport and displaying the product (bulky products take up a lot of shelf space), and wastage, particularly of perishables such as fruit and vegetables. Some companies have employed reasonably sophisticated means to take account of line- or category-specific distribution and retail costs. For example, direct product profitability is a measure used by some companies (described in Chapter 8) in which profits for each category are compared to the area of the store allocated to it. This can be used as a guide to the optimal use of space. However, even in these cases there is no attempt to equalize profitability across product categories.

7.24. Supplier costs, own retailing and distribution costs, sales rates, seasonal availability and currency fluctuations were all named as factors that may influence pricing. KVI and established commodity products were named as areas where margins were likely to be lower than slow-moving and innovative products. Promotions were also a major factor in determining pricing policy.

7.25. The parties will also make strategic decisions as to where to pitch their pricing relative to competitors, for example if they move to a different pricing strategy (such as EDLP). Tesco told us that a large proportion of its price cuts had been delivered through a series of initiatives in which prices had been cut on several hundred products at once.

Price bands and benchmarking surveys

7.26. We asked the companies whether they divided their products into classifications such as KVIs, core lines, own-label or other classifications that might be used either to monitor prices or to distinguish between different pricing policies.

7.27. Although the companies all recognized these terms,¹ many said that no such distinctions were used for the purpose of pricing policy, which applied equally across all product lines. Some surveyed product prices on the basis of baskets which accord with these definitions but which they said did not directly determine pricing policy. Where price monitoring of competitors occurred, most of these exercises appeared to divide along lines between KVI and other products, although some comparison baskets were sufficiently large that they extended well beyond just KVIs. However, some companies did acknowledge distinctions between core, KVI and background lines; and all relevant parties understood the classification of budget own-label lines. For example, Sainsbury considered three tiers: KVIs covered 334 lines (nearly 9 per cent of sales), secondary value items (SVIs²) 358 lines (over 5 per cent of sales), and 'frequently purchased products' another 2,200 (over 21 per cent of sales). Safeway categorized its Saver (budget own-label) lines together with KVIs; these 600 products accounted for 13 per cent of sales. 'Match lines' covered 3,600 lines (22 per cent of sales). The rest were designated as background lines. These two companies also operate separate policies on their budget own-label lines to ensure that these are not undercut. Tesco told us that it did not use any such price band categorization and that its price baskets did not equate to such categorizations. Somerfield distinguished 'top seller' (52 per cent of sales), 'foreground' (33 per cent of sales), 'background' (13 per cent of sales) and 'Basics' (budget own-label) lines (2 per cent of sales). CWS described three tiers apart from background lines; there are around 300 price guard lines but the exact number varies widely by store. Two further categorizations are its 'Top 500' and 'Top 1,500' products. Waitrose told us that its '300 price check' basket could be considered as KVI products.

7.28. All the parties undertake regular price surveys to monitor competitor prices. These monitoring activities are described in Appendix 7.1 and tabulated in Appendix 7.4.³

7.29. We were told that the price surveys were used to ensure the competitiveness of individual products, and to check that pricing was not out of line with that of competitors. They could also be used

¹The precise understanding of KVI or other categorizations varies from party to party, and they would not all agree as to which products fit under any particular classification.

²A selection of product lines comprising the second 50 brands and of a number of other popular products selected on the basis of customer research.

³There are a variety of approaches to how many products and competitors are monitored. The frequency of monitoring also varies in many cases between high-selling lines and KVIs, and background lines. The number of competitors surveyed may vary in the same manner. Monitoring may be carried out through covert price collection, or alternatively research companies process and provide EPOS-based data.

to ensure that a company achieved an overall target for its relative price position, through comparisons of a basket of products.¹ In this case, particular lines could be allowed to deviate from the relative price target, but the target must be achieved either at category level or overall. Many of the parties told us that their buyers were expected to know competitor prices for all the lines they were responsible for, even if these were not formally surveyed on a regular basis. This applied to any relevant competitors, as well as the parties. Some responses referred to the practice of major suppliers, such as Procter & Gamble and Lever Brothers, of surveying prices between retailers and distributing these together with a recommended price list.

7.30. The parties drew our attention to the difficulties in undertaking these comparisons. Any company trying to benchmark against competitors needed to ensure that its comparisons were fair, like-for-like measures. It therefore needed to ensure that product quality was comparable and to adjust for differing package sizes. Such considerations introduced a degree of subjectivity into the exercise. The companies pointed out that such monitoring was expensive, and product comparability might constrain the exercise. Price positioning could also be inferred for products from similar lines (as an example, it would not be necessary to price check every flavour of a given variety of canned pet food, as they were all likely to be similarly priced). Inferences could also be made from different pack sizes of the same product, or similar products and brands. Therefore there was no need for benchmarking to cover all product lines to be effective across all of a category.

Price focusing

7.31. Many of the parties split their product ranges into different categories. We also observe that the intensity of price monitoring varies between products, according to core, KVI or background line status, or according to various baskets of products that may to a greater or lesser extent equate to these distinctions. Budget own-label brands are also intensively monitored by all the parties that stock them. In Appendix 7.1 we also see that in some cases pricing policies vary in line with these distinctions. Other companies, even if they do not use these classifications, may monitor and set prices according to pricing baskets that are distinguished along similar lines.

7.32. This suggests that some parties may consider certain lines more important than others for the purposes of competition. Specifically, attention may be focused on a limited number of lines, which the retailer will seek to price very competitively, with less competitive pressures exhibited on other background lines. Although the precise lines singled out for attention will vary from retailer to retailer, pricing policies and levels of price knowledge of many of the parties seem to reflect this distinction. We note in later sections (for example, on price matching and price wars) that some core products can at times display vigorous and extreme competition between several retailers to an extent not observed on other lines.

7.33. The parties were generally critical of the idea that their price monitoring might be focused in the way described or that competition might consequently be focused on a limited number of products. They told us that they did not perceive the market this way, and that their price monitoring of specific baskets of products, the use of pricing groupings for pricing purposes, and the focusing of particular rounds of price cutting on specific products all arose because of the costs of monitoring and changing prices, rather than a focused approach to competition. Tesco said that monitoring of its national basket was not confined to KVIs, but was drawn from across the range to be representative of the whole range. It said that price cuts on some lines in due course permeated through the product range, that consumers were very concerned with the overall price of the products they bought,² and that market share gains and losses clearly reflected this. It also pointed to consumer survey data which indicated a high degree of consumer sensitivity to price differentials.

¹This is the source of the data discussed in Appendix 7.2 concerning inter-company price comparisons.

²Safeway told us that the fact that a limited number of KVI lines were priced very competitively did not mean that the customer was, ex ante, insensitive to the costs of other items purchased or to the cost of the total shopping basket. Where customers considered the cost of the total basket, supermarkets could not impose higher prices on the majority of lines.

The extent of market-led pricing

7.34. We attempted to identify broad categories of companies on the basis of their policies on relative pricing. The parties' declared policies, including other influences on pricing, are covered in Appendix 7.1. Four groups are categorized on the basis of some common observed behaviour. However, any individual company is likely to display some behaviour which may be better attributed to other groups, and so this categorization is for broad descriptive purposes.

Group 1

7.35. The first group consists of the limited range discounters. These all try to occupy a position at the lowest end of the price range. Aldi claimed that it would usually lead price reductions, as its policy was to sell to undercut the main multiples. However, it would also match price cuts on commodity and KVI products. Lidl described a primarily reactive pricing policy. It observed the lowest price of its competitors at the same quality and nearly always matched it. However, there were instances where Lidl would initiate a price reduction. Netto's pricing was partly reactive; it aimed to be the cheapest, or failing that, to match the cheapest with a better-quality product.

Group 2

7.36. The companies in Group 2 generally view their price setting as pro-active and aggressive. They will try to initiate price reductions, and ensure that overall they can beat competitors.

7.37. Asda told us that its policy aim was to achieve a 5 to 10 per cent price advantage against the average in the market.¹ However, basket surveys were used as a check on its overall pricing rather than to allow a specific policy of price shadowing product line by product line, except on core items which it would price match against the lowest-priced competitor. It said that it did not track any one competitor and was no more likely to respond to one than another.

7.38. Morrison told us that its aim was to seek the lowest commercially possible prices, which should give it a price advantage, but no policy statement was made regarding relative prices. It said that its price changes were sometimes triggered by competitors.

7.39. Tesco claimed to have no overall price difference target other than to get cheaper over time, although it did have a specific long-term target of being the cheapest on its national basket after Kwik Save. The national basket covered 3,500 major lines at the time of our main party questionnaire (expanding to 4,000 by June 2000) and Tesco said that it was continuing to expand this. Tesco told us that its price initiatives were not competitor determined and that it tracked overall competitiveness, not individual product lines. However, other Tesco policies meant that particular lines had been at times constrained with regard to pricing by competitors. There was temporarily a price pledge on 650 lines (which ended in July 1998) that it would not undercut. For 200 lines (covering 4 per cent of turnover) in the 'value' basket of budget own-label products, Tesco store managers could ensure that they were not beaten by competitors within a mile of the store. On the national basket (increasing from 44 to 49 per cent of turnover), Tesco aimed not to be beaten on price by the five largest chains for each of these products. On the general basket (which was everything not in the national basket), no product might be beaten by Safeway or Sainsbury. Metro and Express stores had different baskets where higher prices might be charged. Tesco told us that most price cuts had been delivered through a series of large-scale price initiatives where several hundred product prices would be cut at once.

Group 3

7.40. The third group of companies told us about policies that were more reactive in their price setting, where they responded to competitors' price adjustments.

¹Asda told us that this was being increased to a 10 to 15 per cent price advantage.

7.41. Sainsbury's overall goal was to achieve a level of prices within a given range of Tesco and Asda, having regard to competitive prices, margins and balancing quality and prices. On the budget own-label range, prices were set so that they were not undercut by key competitors (the larger multiples). Other than for economy and KVI lines, the goal was not necessarily price parity, although Sainsbury would seek to be very close in price on SVIs, and on other categories, within a reasonable margin. There were exceptions if Sainsbury did not believe the comparison was of a similar quality, or Sainsbury could not achieve an acceptable quality in the same price range. However, there were instances where Sainsbury did cut prices first, and examples were provided where it took the initiative in price reductions.

7.42. Safeway's policy in 1999 was to benchmark price changes primarily against Tesco. This reflected its view that Tesco would price accurately to reflect competition. Although Safeway set prices with regard to various overall criteria, its policies imposed a maximum price for every comparable product line. On KVI and Saver (budget own-label) lines (some 600 products), prices were set not to be above Tesco in any store. On 'match lines' (the next 3,600 lines) in low and mid price-band stores (representing 84 per cent of sales) prices could not be higher than Tesco, while in high price-band stores (16 per cent of sales) prices were slightly higher than Tesco. On background lines, in low and mid price-band stores, prices were also slightly above Tesco, and in other stores, a larger gap was allowed. Additionally local managers had discretion over 30 product lines. Safeway confirmed that it would match prices on KVIs, and would lead permanent price reductions on a specific range of goods. Competitors would often respond to these price changes. Safeway informed us that its pricing policy had changed in autumn 1999. A higher-priced tier was retained for stores that were remote, or town centre or convenience stores, which it said reflected higher costs. Otherwise uniform prices applied, which were benchmarked against industry average prices rather than particular competitors. However, different sets of deep promotions on a limited range of products were circulated around groups of their stores. Additionally, store managers might be given some discretion over the local pricing of a small number of lines.

7.43. Somerfield's non-promotion changes were triggered by the price changes of defined benchmark competitors. Generally it aimed for a constant differential against nominated competitors, to match certain competitors on frequently purchased items, and to match Tesco on basics (budget own-label brands). Prices of less frequently purchased lines were also benchmarked against some of these competitors but there were four different rates of mark-up on this depending on the store format and conditions.

7.44. Kwik Save aimed to be cheaper on its benchmarking basket than any of the major four multiples. By product, it aimed at least to match Asda on price, and to maintain any existing price advantage. In some stores actively competing against a discounter, prices were set to match that nearest discounter on a range of products. Consequently, Kwik Save's price changes were nearly always triggered by price changes in nominated competitors.

7.45. In the main, Budgens matched Tesco pricing in its primary stores, with higher prices for other formats. Consequently around half of business was at Tesco's pricing levels. Budgens stated that its aim was to be reactive, and to follow the market leader to stay competitive.

Group 4

7.46. The fourth group comprises companies which, while taking competitor prices into account, appear to be less concerned to maintain any explicit or stable relationship with them over the broad range of their offer.

7.47. CWS answered on behalf of all the Co-ops within the inquiry's terms of reference. It told us that it aimed to be the market leader in pricing among convenience stores, but to be reactive so far as its superstores were concerned. Of its four store price bands, the lowest price band 1 was intended to be broadly competitive with a multiple competitor's superstore. Tesco was most actively monitored, but others were also examined. The Everyday (budget own-label) range was matched against Tesco pricing. However, it had no specific product line policy other than to be competitive against competitor superstores. The other three price bands for progressively smaller stores each involved an average 5 per cent uplift on the previous price band. However, KVIs might be priced equally in all shops and a price guarantee was applied to some 300 products to match the lowest-price multiple competitor.

7.48. Booth aimed to match or beat competitors as necessary, but it would not always reduce prices: for example, it sought to avoid below-cost selling. However, it said that it had to be competitive over a broad range of KVIs against a range of competitors.

7.49. Waitrose told us that it would take account of competitors' prices throughout its range but especially on standard items, where it aimed to beat, match or be only slightly above competitors. Its specific price commitment applied to some 320 KVIs, accounting for 8 per cent sales. However, Waitrose said that given the practical restrictions on relative pricing, there was a knock-on effect to other product lines accounting for around 15 per cent of sales.

7.50. Iceland monitored the market but had no policy of tracking particular parties or pricing in response to them. It was only when it felt out of line with the general market that it would change prices.

7.51. M&S had no corporate policy on beating or matching competitors. It said that it kept in touch with market prices to maintain position but emphasized quality rather than price as a selling point. Consequently, major multiples might trigger a price change but this varied by department.

Summary

7.52. We observe differing behaviour between the four groups identified above. However, the largest parties all appear to price-match competitors on at least some items, typically core and budget own-label lines. In later sections we consider, first, whether there are differing degrees of competition between the core, KVI and budget own-label lines as opposed to background lines, and second, whether price-matching behaviour and the certainty of it occurring can in fact inhibit the extent of price cutting. Alternatively it may channel price cutting into situations where matching reductions is difficult to achieve, for example on promotions.

Other influences on price

EDLP strategies

7.53. It was put to us that the pricing policy adopted primarily by Asda, but to an extent also by some other parties, which was characterized as EDLP, represented a shift in the pricing behaviour of UK multiples. It was suggested that the previous behaviour of the major multiples was to selectively promote particular lines for limited periods, in what is sometimes called a 'high/low' pricing strategy. However, EDLP is designed to reduce greatly the number of promotions and instead devote the money saved, including if possible the supplier contributions to promotions, into permanently reduced prices. As an example, Asda told us that its 'Rollback' programme progressively applied this principle of non-temporary real price reductions to wider ranges of lines (with a target of 10,000 lines by the end of 2000).

7.54. It was put to us that this strategy, while having some attractions for consumers, could eventually be detrimental to the competitive structure of retailing. We were told that a true EDLP strategy could only be fully pursued by the lowest-cost operators, and could end up concentrating market share in its hands, increasing market power and ultimately generating higher prices than would otherwise have occurred. An EDLP strategy could be pursued to give a particular chain a reputation for low prices. The largest player would be the most likely to be able to exploit scale advantages and make this succeed. Once the perception that all prices were lower than the opposition had been achieved, customers would stop making comparisons between multiples or seeking out bargains, even if these were offered by rival promotions. At this point, we were told, the dominant player would then be able to increase prices.

Northern Ireland

7.55. We considered whether Northern Ireland might be regarded as a separate market for pricing purposes. Sainsbury told us that prior to it, Tesco and Safeway entering the Province, prices were on average 17 per cent higher in Northern Ireland than in Great Britain. However, all these parties told us that they had applied their national pricing strategies in Northern Ireland, eliminating any price

difference with the UK, at least for the proportion of products where the ranges stocked were common. Tesco said that 100 products were priced differently in Northern Ireland because of their importance to consumers there. The prices of some of these products were less than in Great Britain, and others higher, but overall Tesco told us that the prices were broadly in line with the rest of the UK. The GCCNI told us that it had carried out a survey in November 1999 to test whether Tesco's pricing policies were being applied equally in respect of Great Britain and Northern Ireland. Its conclusion was that this appeared to be the case, subject to the limitations of sampling error.

Pricing tactics

7.56. During the course of our inquiry, eight issues emerged as important. These were: promotions, loyalty cards, price matching (including price wars), local price flexing, below-cost selling, price leadership and following, own-label pricing, and the transmission of supplier prices to retail prices.

Promotions

7.57. Most companies within the industry make extensive use of promotional strategies. We consider promotions relating to particular product lines, rather than generic promotions such as general advertising, sponsorship of sports or arts, and charity promotions. The main parties' policies on the use of promotions are described in Appendix 7.1. Promotions alter the effective price or quantities of product purchased, or in some other way provide an incentive or benefit to the purchaser. The defining feature is that such promotions are of temporary duration. Promotions are typically on a two- to four-week cycle, and retailer-initiated promotions are rarely more than six weeks in duration.

7.58. A promotion can serve several aims. It can raise the profile of a product, and tempt consumers into trying something new. As such, it allows multiples to develop new areas or products, with benefits for the retailer and supplier, and indeed opens up new opportunities for consumers. It also allows an underperforming area to be revived. It may allow sales to be boosted in a product with elastic demand, with the hope that this is not at the expense of lost sales on substitute products. It was also put to us that a company that did not have the lowest cost base could promote itself on the basis of price, in a way that it could not if all parties followed an EDLP strategy. Therefore it may allow a relatively higher-cost retailer to compete on price with its lower-cost competitors.

Types of promotion

7.59. There are many potential types of promotion. The list below covers the major promotional categories that are used systematically by retailers and suppliers to promote particular lines in the form of direct incentives to purchase:

- discounted price, eg 20 per cent off;
- free product, eg 20 per cent extra;
- multisaves, eg BOGOF, buy two get one half price;
- linksaves, eg buy product A, get product B free;
- couponing: money off next purchase coupon on pack;
- cross couponing: money off subsequent purchase coupon on pack for a different product;
- money off coupon prior to purchase, delivered door to door, in magazines and newspapers, loyalty mailings or at till; and
- bonus loyalty card points.

7.60. The mix of different promotional formats varied from party to party, although they all tended to use a mix of price reductions and multibuys. Other schemes such as linksaves and bonus loyalty card points varied between parties. Promotions were nearly always applied on a national basis, rather than being region- or store-specific, although Safeway's new tactics involved local promotions.

7.61. Products may be promoted in other ways, such as raising awareness through in-store advertising and sampling (for example, product tastings), distributing free samples, at store, door to door or direct mailing, and point-of-sale impact, for example displays or positioning in store, such as at gondola ends. Products may be promoted through new packaging, new recipes or formulations, attached franchise (for example, branding it with popular characters, films or children's programmes), or attaching competitions and games.

7.62. The limited range discounters told us that they did not in general make use of promotions as described above. They did describe a programme of offering limited quantities of special purchase products, often outside their normal grocery offering, at low prices on a temporary basis. However, these were not promotions in the sense of a temporary incentive on a regularly-stocked product.

7.63. Some of the larger companies which are moving towards an EDLP strategy stressed that they were reducing the number of promotions that were on offer. However, none of the major retailers had completely eliminated them.

7.64. All other parties made extensive use of promotions, which were a major part of their competitive strategies. The large multiples except Asda offer between 500 and 1,500 promotional lines at any one time, and these can account for up to 30 per cent of sales. Promotions are seen as an attractive competitive policy, as it is very difficult, and hence unusual, for competitors to respond to a temporary promotion.¹ Some differentiation from competitors can therefore be achieved without provoking a reaction from these competitors. The parties stated that promotions were usually planned several months in advance in agreement with suppliers, as promotions typically involved a great increase in sales. Consequently, competitors were unlikely to be able to respond in kind. As examples, the average volume uplift per line on promotion could be 200 per cent, while large multiples reported that the increase in sales could be up to 3,000 per cent for a BOGOF-type offer. One smaller multiple reported an example of a promotion showing a 4,400 per cent uplift in sales.

7.65. As well as promotions being attractive in their own right, the temporarily lower effective prices combined with an uplift in sales mean that the effective overall price of the supermarket basket can be substantially reduced. Consequently, differences in promotional offerings may affect apparent price gaps between rival multiples.

7.66. Products on promotion can represent a significant proportion of sales. Four of the six largest multiples provided an estimate of the proportion of their sales that were of products on promotion; varying from 12–15 per cent up to 25–30 per cent. One of the smaller multiples reported a figure of 34 per cent.

7.67. We were told that there were some exceptions to the generalization that competitors would not respond to promotions. Safeway referred to the case of Christmas turkeys where promotions were matched; consequently prices could fall to very low levels. CWS claimed that competitors did watch promotions and might react to advertised deals if they were on products that might be considered as 'core' lines. Other parties told us that there was occasional evidence of larger competitors responding to promotions, although no evidence was presented that could establish that the competitor had not intended to run the promotions in any event.

7.68. Companies tended to want their promotions broadly to cover the whole range of their offer, but in many cases the motivation for the promotion was from the supplier. Several mentioned that surplus supply could trigger a promotion, and referred to seasonal promotions, special events (for example, a tie-in to the World Cup), calendar events (Christmas and Easter), to promote new product launches, and to develop a category.

¹Sainsbury told us that competitors might respond to temporary price reductions, although not multisave offers.

7.69. We consider that there is a limit to the number of promotions that can be launched effectively at any one time (due to supply chain disruption and loss of margin), and there are costs involved that will be only partly offset by supplier contributions. The parties listed the costs they perceived in operating promotions (Table 7.1).

TABLE 7.1 **Costs of promotions borne by multiples**

<i>Direct</i>	Own margin investment Point-of-sale costs (production, distribution and implementation) Labour costs in-store Marketing expenditure
<i>Indirect</i>	Management time Consumer switching Distribution/supply chain costs

Source: CC summary of party responses.

7.70. Consumer switching means that in many cases purchases are just transferred between products or brought forward in time rather than being net additions to sales. Consequently, it is difficult to evaluate the net value of promotions.

7.71. In our exploration of price leadership (see paragraphs 7.179 to 7.203), we obtained time series of prices for 18 products from the major parties. Examination of these series shows that promotions (defined as temporary changes in price where the cut was roughly 5 per cent or more, for a period of less than six weeks) were very frequent, although some parties had difficulties in recording their promotional history. What stands out is that some products are the subject of frequent promotions by all these multiples, while others are only rarely promoted. Of the 18 items examined, bread, chicken, instant coffee, Kellogg's cornflakes and PG Tips tea bags are examples of products with frequent promotions, while milk, eggs and sausages have very few promotions.

7.72. There is also a difference between the multiples in the frequency of promotions in this small sample of products. Sainsbury had the most promotions, followed by Safeway. Sainsbury's promotions also tended to be bigger in terms of proportional price cut. In the available sample Sainsbury and Tesco on average had longer promotions, of the order of two to four weeks.

Concerns about promotions

7.73. A number of concerns were put to us about promotions. A promotional strategy might be misleading if the consumer mistakenly inferred from temporarily low promotional prices that overall price levels were also lower. The counter-argument was that careful customers, or those who were willing to be flexible in the products that they bought, had the opportunity to cherry-pick various bargains. As the companies pointed out, customers did like promotions, and our own consumer survey confirmed that customers would seek to take advantage of promotions when they were available, although this did not confirm that they were preferred to consistently lower prices across the board.

7.74. The second of these potential concerns results from the very success of promotions. The temporary sales uplift effect can be very large in some cases. Multiples will seek to avoid being caught out of stock during a promotion, and limited supply 'when it's gone it's gone' promotions would not usually be used for grocery promotions, in the way that they may for clothing, electronic or household items. Consequently, producers need to build up a stock of the product before a promotion. This affects production schedules and distribution, while the demand on in-store storage and shelf replenishment will also increase. There will often be considerable costs and disruption to the supply chain in planning and implementing such promotions. Production schedules can be disrupted, raising costs. Some suppliers regarded such costs as excessive.

7.75. It has been put to us that the benefits of any promotion can be illusory or at least very short term. A promotion will be funded by a reduced margin from either the multiple or supplier, and frequently both. We were told that it was rare for a promotion to be run at a negative gross margin. If margins were normally higher than otherwise in order to fund promotions, or promotions were used to attract basket shoppers into a store, where their other purchases cross-subsidized the promotion, then

consumers might not end up paying less overall. Similarly, suppliers might seek to fund the reduced margins from other sales on other products, or from other retailers.

7.76. It was put to us that promotions might also disrupt customers' price perceptions, an idea that we refer to as 'promotional fog'. Promotions might be used so frequently in some product areas that consumers were not able to form an accurate impression of what a true normal price would be in a particular store for a particular product line. In addition, the widespread use of promotions might distort a customer's perception of the overall value of offer in a particular store, and so they could believe that the overall value for money was better than it actually was.

7.77. It was put to us that some promotions might in effect discriminate against certain types of customers or that certain consumers might be unable to take full advantage of promotional offers. Multibuy offers were given as a particular problem area: many consumers could benefit by cherry-picking and stocking up on promoted items, and those on an extremely limited budget might not have the resources available to do this. Elderly or infirm shoppers might not be able physically to transport bulky or heavy items home. Non-car owners would also be disadvantaged in this respect. Similarly, single person households, or others with a low demand, might be unable to take full advantage of multibuy or extra product promotions. This was particularly likely for perishable products.

7.78. We received some consumer complaints (see Chapter 15) that promotions were misleading, for example that price reductions were quoted against prices previously charged in some of the companies' stores, but not necessarily in those stores that offered the promotion.

Loyalty cards

Background

7.79. We asked the main parties about their use of customer loyalty schemes, the costs associated with loyalty cards and their overall usefulness.¹ In addition, through our consumer survey, we collected information on loyalty card penetration, the impact of cards on consumer switching, and the importance of loyalty cards in store choice.

7.80. CWS, Sainsbury, Somerfield and Tesco offer customer loyalty cards. In May 2000, Safeway announced the discontinuation of its ABC loyalty card scheme that had been in operation since 1995. Details of these schemes are presented in Appendix 7.3. Other parties do not offer loyalty schemes, preferring to use their overall grocery offer to enhance customer loyalty.

7.81. Most of the parties told us that to date, the primary benefit of loyalty cards was the collection of customer information, which allowed them to target better their promotional campaigns and product offerings (except Somerfield which does not collect customer data). Loyalty cards were also perceived as necessary to maintain competition against other multiples that had them. Other benefits they identified included:

- enhancing their value-for-money offer; and
- providing product differentiation.

7.82. Redemption of both grocery and non-grocery items was identified as the primary direct cost associated with loyalty card schemes.

7.83. Around 70 per cent of respondents to our consumer survey held loyalty cards and the average number held was just under 2. Of those that held cards, 81 per cent reported that the cards had not affected their grocery shopping behaviour. Around 2 per cent of customers who held a card had switched stores for a better loyalty card scheme. The survey illustrated that loyalty cards are not a significant specific factor determining store choice, although it could be argued that they indirectly affect consumer perceptions of factors such as price.

¹By loyalty schemes, we mean loyalty cards rather than other types of loyalty programmes.

Issues

7.84. The following areas of concern have been raised in relation to loyalty schemes:

- (a) loyalty cards might unduly increase switching costs for consumers;
- (b) the cost of loyalty cards might contribute to excessive costs which could be funded through higher grocery prices; and
- (c) loyalty cards might impede price transparency.

Switching costs

7.85. Certain loyalty card arrangements have the potential to lock consumers into shopping at a supermarket group, which could have an adverse effect on competition more generally. In particular, arrangements that are designed to restrict or discourage the use of multiple cards could limit store switching.

7.86. Generally, consumers are able to use multiple cards because normally, reward redemption is not time-limited and rewards are fairly uniform across multiples. For example, they offer mainly a straightforward 1 per cent discount by redemption of vouchers, with a low minimum spend. We refer to reward systems where the proportionate rate of benefit from the rewards does not increase with the level or frequency of expenditure as 'linear' reward schemes. For these, there is little cost associated with holding multiple cards and obtaining similar benefits even though purchasing groceries from different supermarket groups. However, schemes that have more generous reward provisions but relatively restrictive qualifying conditions are more likely to impact on store switching; for example, if regular or repeat purchases lead to proportionately higher rewards. We refer to these as 'non-linear' reward schemes. If loyalty cards raise switching costs, consumers may become less responsive to other factors such as price, to the detriment of competition in the one-stop grocery market.

7.87. From the results of our consumer survey and the results of a recent survey published by Verdict, it appears that traditional loyalty cards by themselves do not give consumers much incentive to shop exclusively at one supermarket chain. The Verdict report indicated that Asda had the highest customer loyalty of the multiples despite not offering a loyalty card. In contrast, Safeway had the lowest customer loyalty despite offering a loyalty card over the period of the survey.¹

7.88. While these results reflect consumer views about the importance of loyalty cards versus other factors such as price and quality, they also suggest that the terms and conditions of most well-established loyalty schemes are 'linear' (as defined above) and have not placed undue restrictions on store switching and hence have not distorted competition. Although loyalty cards have the potential to impact on price-related perceptions of a multiple, there are a host of other factors that are currently more likely to be the primary influence on store choice. Such schemes are, however, evolving and more generous reward schemes coupled with increasingly restrictive terms and conditions could be used directly to influence customer loyalty by raising switching costs.

7.89. In addition to its Clubcard scheme, in 1999 Tesco launched a 'Keyholder' scheme, which offers relatively restrictive conditions for the accumulation and redemption of rewards. Under the Keyholder scheme, one 'key' is awarded for every £25 spent in a single shopping trip. Customers need to collect 50 keys to become a keyholder and qualify for a 50 per cent discount on Clubcard deals. Keys expire after one year. Therefore, a customer who spends between £25 and £49 on each shopping trip would have to shop at Tesco on at least 50 occasions in one year. Keys cannot be used for any other purpose (such as discount on groceries), but points are still accumulated for regular Clubcard rewards at the same time.

7.90. Full participation in the Keyholder scheme has the potential to reduce a customer's longer-term switching opportunities because, to qualify for rewards (for a £25 to £49 weekly grocery spend) a customer would have to shop at Tesco almost every week for a year. Shopping elsewhere for a few

¹'Bitter supermarket war leaves loyalty cards unloved', *The Independent*, 31.1.2000.

weeks could therefore lead to a substantial loss of benefits. By increasing the incentive to use one card, these factors could become a barrier to store switching that could limit competition.¹ As the Keyholder scheme has only been recently introduced, there is no evidence as to how successful it has been, or what its impact, if any, on switching has been.

7.91. Some schemes such as Sainsbury's Reward Card and CWS's Dividend Card offer bonus reward points or dividend for the purchase of selected items. However, we consider these as equivalent to ordinary promotions given the current 'linear' structure of their incentives system.

The cost of loyalty cards

7.92. The parties informed us that over 1998/99, in terms of redemption costs, Sainsbury's rebate programme cost £[] million, Tesco's rebate programme cost around £[] million (with running costs of £[]million), Safeway's cost £[] million (after £[] million of supplier contributions), Somerfield's cost £[] million and CWS's cost £[] million.

7.93. While in theory multiples offering such schemes should benefit from loyalty cards through increased sales and brand loyalty, because of the difficulties in isolating other effects on sales, most multiples could not identify any long-term sales benefit from their loyalty card programmes.²

7.94. Loyalty cards are a sizeable cost for the relevant multiple and it is possible that long-term sales uplift may not always absorb the costs. If multiples do not totally offset the cost of loyalty schemes through higher long-term sales, there are a number of funding options. They may reduce other types of promotional expenditure; they may absorb costs through lower profits; or they could charge grocery prices above competitive levels. Loyalty cards provide a source of consumer information for multiples that may save on other consumer research and marketing costs. Thus, Tesco told us that the loyalty card has allowed it to lower other types of advertising expenditure.

Price transparency

7.95. Loyalty cards may have the effect of impeding competition by reducing price transparency. Instead of offering lower grocery prices, multiples with market power could operate behind the 'fog' of loyalty card discounts, which may have the potential to make comparisons of actual grocery expenditure more difficult.

7.96. It was found in our consumer survey that there was no evidence that loyalty cards affected the ability of consumers to recall the prices of particular products. Similar recall rates were achieved by shoppers regardless of whether their favoured stores used loyalty cards. However, the concern remains as to whether the ability to compare the overall cost of a main shop is impaired.

Price matching and price wars

7.97. Some products appear to sell in all supermarkets at the same price. Such behaviour may be consistent either with intense price competition or a situation of little competition, because multiples all understand that an attempt to obtain a price advantage will be matched, and hence prove unsuccessful.

7.98. The main parties were asked for their views on why certain products tended to have uniform prices in all supermarkets; for example, bananas being 99p per kg (45p per lb) in all stores (previously 108p per kg (49p per lb)) was given. They were asked to explain the dynamics of the price being the same across stores, and how they could be said to be competing in respect of such products.

¹Data from our consumer survey indicate that 80 per cent of households spent at least £26 per week on their primary grocery shop at supermarkets, with just over half spending at least £51 per week. Under the Tesco Keyholder scheme, a majority of households undertaking their regular primary shopping would qualify for keys, provided they shopped in its stores often enough.

²CWS told us that the cost of its loyalty scheme had been offset by an uplift in sales and margin mix.

7.99. We were told that such pricing behaviour could arise on a limited number of core KVIs. These were the very obvious lines that many consumers would be expected to purchase, and which might be used as representative products by consumers when they tried to form impressions of price between stores. We were told that highly visible core lines were crucial to the price perception of a store; therefore virtually all multiples track prices for these products. CWS said:

Most retailers believe that customers judge the price positioning of their main trip shop on the basis of a few hundred Known Value Items, where there is a customer expectation as to the 'right' price. A retailer selling above that price would be regarded as expensive, and would risk losing customers. There is therefore a tendency for all main trip outlets to sell the KVI at more or less the same price, as each refuses to let the other have an advantage. The main products involved are likely to include milk, bread, spreads, produce, sugar, meat, frozen foods, and certain canned goods and beverages. It has to be said, however, that there is more 'folklore' than hard evidence as to which products the average customer is actually aware of the price.

7.100. Similarly, Asda told us:

... there is a small group of product lines comprising branded, own-label and cheapest on display lines (including, for example, COD white sliced bread, milk, bananas and bagged white sugar) in relation to which it is in practice virtually impossible to establish a pricing differential one way or the other vis-à-vis all competitors since any move in price will tend to be rapidly tracked. It should, though, be emphasised that the products concerned are few in number and doubtless different store groups would have different views as to what the products concerned were.

Asda estimated such core products accounted for about 1 per cent of sales.

7.101. Somerfield told us that in the case of bananas, prices were stable because quotas restricted banana supply. Promotions were therefore difficult because increased supplies were not readily available. However, bananas are for most retailers the single highest-selling product line,¹ and so are exceptionally visible. Somerfield attributed price equalization to the fact that these were high-volume rather than highly visible lines. It told us:

... because consumers evaluate prices mainly on the basis of the cost of a 'basket' and KVIs form the majority of the value of a consumer's basket, retailers have to price match on high selling lines or they produce an uncompetitive basket. If one retailer undercuts the price of a high volume line, others will follow and rematch the price. We have seen a lot of this type of cut and react activity in the market over the last 3 or 4 years and it is reflected in the low food inflation figures. It is currently happening at a particularly high level, with all the majors initiating pricing activity. Evidence of price matching in UK grocery retailing is therefore, evidence of a very competitive market, not an uncompetitive one.

7.102. It should be noted that even on core KVIs, operators outside the conventional broad-range supermarket offer are able to deviate from this market price. For example, Aldi could still at the time of our questionnaire undercut the main multiples in relation to bananas without provoking a reaction from the major multiples, and M&S could charge a higher price.

7.103. Tesco challenged the significance of such activity. It assembled a dataset of 850 product lines over a period of 68 weeks from the first week in March 1998 to the last week of June 1999. Prices were surveyed in Asda, Kwik Save, Morrison, Sainsbury, Safeway, Somerfield and Tesco.

7.104. It reported that only 37 products—around 4.35 per cent of the total products in the sample—had the same price across all retailers monitored for at least one week over the sample of 68 weeks. Of the 37 products, only two were the same price in all retailers for half or more of the sample period. The average number of weeks spent at the same price in all retailers for these products is 12.7 weeks out of 68, or around 19 per cent of the entire sample period. Only 14 products had identical prices for more than

¹The relatively high sales occur mainly because loose bananas are just one single product line, whereas, say, coffee will cover many different variants and pack sizes, and hence a great many separate lines.

ten weeks. Tesco described 25 products out of 37 as ‘standard’ products, such as own-label beans or spaghetti. Many of these were budget own-label variants. The other products were well-known branded lines, ie Kellogg’s cornflakes, Bird’s Eye peas, Uncle Ben’s rice, Tetley tea bags, Heinz soup, Huggies, Choosy, St Ivel multipack yoghurts, KitKat multipacks, Cockburns port and Famous Grouse whisky. Tesco also provided yearly sales data for these products. It was noted that on the basis of its data, the total sales of products sold at the same price in all retailers in 1998/99 was just over 2 per cent of total turnover.

7.105. Tesco therefore concluded that very few products were the same price in all stores, and those that were accounted for a minimal proportion of sales. Further, products that were the same price in all stores remained so for only a limited proportion of the time. It said that equal prices often occurred temporarily as a by-product of the competitive process of price setting.

7.106. We consider that the Tesco evidence is useful to establish that ‘common pricing’ is not observed across all retailers, and is confined to a limited number of products, or limited periods of time. However, its methodology required common prices across all seven competitors that it surveyed. It could be that the five largest retailers’ main fascias do all have common prices every week yet this would not be identified by Tesco’s methodology. Also, if one company changes its price and others respond in kind with a lag, the above results would not report this as an example of price matching.

7.107. Given the acknowledgement of this phenomenon from the other parties and their descriptions of the circumstances and reasons for it, we conclude that price matching does occur. However, we accept that it may be confined to a relatively small number of products and may not occur continuously. This section does not consider whether prices are reasonable; common pricing can be consistent with intense competition or the wish to avoid self-defeating price cuts.

7.108. Morrison told us that for core KVIs, where competition was in the form of never knowingly being undersold, this environment could create very low gross margins. Similarly Iceland stated that identical prices often resulted from competition driving prices to the lowest common denominator. The smaller parties agreed that margins tended to be pushed to very low levels on such products. Indeed, paragraphs 7.153 to 7.178 show that some products are sold at a negative gross margin, some of which are cheapest on display lines or well-known branded products.

7.109. We were told about instances where ‘price wars’ had developed on particular products, such that prices were driven down to very low levels and were matched by several multiples.¹ For example, cheapest on display sliced white bread prices fell to very low levels (down to 7p a loaf) in spring 1999 for several supermarket chains.

7.110. We were told that the circumstances described in paragraphs 7.99 to 7.101 created the conditions where price wars could develop. For example, Sainsbury said ‘There have been price wars in relation to baked beans, bread, milk and—most recently—bananas. There tends to be more overt competition on these products because they are seen by competitors as providing a ready signal to consumers about the price competitiveness of the store’, and ‘[Sainsbury] has responded to price wars by reducing prices significantly ... Recently its price for Economy sliced bread fell to just seven pence in response to an initiative started by Asda/Tesco’. Its research shows that failing to compete on a single key item may cause consumers’ overall perception of a store to change and as a consequence, for sales to suffer. If one party deviates from a common price situation with a pledge to beat all competitors, yet others have pledges not to be beaten, then there can be a rapid decline in prices.

7.111. Netto said that its main competitors were financially strong and so could sustain loss situations. All of these were able to respond to price cuts and, if they did so rapidly, it nullified any advantage gained. However, price reductions levelled out when competition reached negative profit levels.² Certain high-volume, highly price-elastic lines demanded keen pricing, and caution on further reductions was therefore inevitable. This suggested, it believed, that price stability would then be a feature of pricing after a price war.

7.112. However, it is not clear that all cases of price matching are the result of such circumstances. Moreover, no parties provided an explanation of how prices recover after a price war. Not all products

¹Some parties stated that they would not get involved if they saw a price war developing, or only up to a limit.

²Asda told us that price wars could end before negative margins were reached.

are subject to intense price wars and, for some, prices may remain above costs for long periods of time. Issues of profitability are addressed in Chapter 8.

Local pricing

Introduction

7.113. Uniform prices need not be charged for identical products in every store within a group, even under a common fascia. Differential pricing was an area of concern for the DGFT, particularly if stores sought to exploit local monopoly power. After the OFT's initial investigation into grocery pricing, the DGFT reported his concern that '... grocery prices are often set to match competitors rather than to undercut them particularly in catchment areas where consumers have a limited choice of supermarkets'.¹ We refer to the variation of prices for identical products between stores of one group as price flexing.

7.114. We undertook a number of exercises to investigate how parties varied prices for identical products between stores. We sought to determine how many products, and of what type, had variable prices, to identify the extent of these price differences, and to determine the reasons why companies decided to change prices. We then considered whether such price adjustments had any impact on competition, and whether there were any concerns over such practices.

Company policies

7.115. We asked all the main parties to provide an account of their pricing policies and practices with regard to price flexing. Budgens, CWS, Netto, Safeway, Sainsbury, Somerfield (including Kwik Save) and Tesco all indicated that they might charge different prices in different stores for at least some products. All others claimed to operate a uniform national price list, ie that all products were sold in all stores at identical prices.² In some cases there might be variations in the lines stocked between stores, based on their size or regional tastes. This analysis only considers price variation of identical lines. Asda told us that it moved to a uniform national pricing policy in November 1998. Lidl had at times also operated a non-uniform pricing policy, but it told us that this was not the case during our investigation. Company policies are described in Appendix 7.5.

7.116. It was suggested by most of the parties that prices could be varied in response to the different costs that different stores might face. In particular, smaller stores and town centre stores typically faced higher proportionate operating costs. Some geographically isolated stores might also face higher transport and wastage costs. Older stores might face higher operating costs because of poor or inappropriate store layout. Several of the parties had chosen to present different classes of store under different fascias or brands, corresponding to different sizes of stores and ranges of product lines stocked. Price schedules may vary between stores according to these fascias, or they may vary according to store size, or other indicators of cost.

7.117. Some companies charged higher prices in stores that tended to offer convenience and top-up shopping. Such stores may typically be located in town or local centres and typically have a much lower level of sales per customer. They are not primarily one-stop shops. It was argued that such shops tended to have higher operating costs and wastage, and that the products that they typically sold (for example, tobacco, alcohol, and staple essentials that may be needed on an emergency basis, such as bread and milk) tended to have low gross margins when sold by supermarkets. For this reason it was argued that convenience stores must charge higher prices. Further, consumers recognized and tolerated the need for higher prices in smaller stores, and were willing to pay some amount extra for the convenience.

7.118. In addition, a number of companies acknowledged that prices might vary according to the profile of local competition. Budgens said that a store might be on different price tiers for different products depending on local circumstances. Safeway told us that under its early-1999 policies, the price

¹OFT Press Release (see Appendix 3.1).

²Exceptions were allowed for purely temporary effects from clearing end-of-shelf-life stock, and if the process of changing prices could be spread over a few days if not all stores within a group changed their prices on the same day. However, promotions which effectively reduced price would need to be applied equally in all stores for a uniform national price list to apply. M&S indicated that occasionally it could operate store-specific promotions.

schedule employed could vary according to the intensity of local competition. Additionally, Safeway's local managers had discretion to price 30 products according to local market conditions. Somerfield told us that stores directly competing with major multiples and where there was intense local competition provided lower prices for selected product groups. Pricing might also respond to local demographics. Kwik Save stores would try to match a hard discounter on selected product lines, if they were in direct local competition. Tesco told us that stores might be designated as 'local' stores if they faced 'price-sensitive customers', or occasionally in response to changes within a store's market, such as new competitor openings or store extensions. On its 200 Value lines, store managers monitored local competition and could lower prices to match local competitors.

7.119. Asda suggested in its evidence that some competitors appeared to price down to meet Asda's price challenge in some areas, or might respond to price reductions in some regions before others. It was put to us that some competitors effectively operated regional pricing.

Extent of price flexing

7.120. We obtained pricing data from the companies to conduct our own analysis. The method of data collection and analysis is described in Appendix 7.6. Price data were collected for up to 200 products at up to 60 stores for each party on 28 January 1999. These data were then used as an indication of the patterns of price flexing in each company.¹ We constructed a sales-weighted basket of prices to calculate a price index for each store. This index is expressed as a proportion of the average of the prices charged in all the stores for that chain. The products surveyed do not necessarily constitute a representative selection of all lines sold. Table 7.2 describes the unweighted incidence and extent of price flexing.

TABLE 7.2 Extent of price flexing based on sample data

<i>Company</i>	<i>Number of products</i>	<i>Number where price is flexed</i>	<i>Greatest price range for any product (relative to the cheapest price)</i> %	<i>Average range in price for the flexed products only (unweighted)</i> %
Budgens	155	100	62	9.8
CWS	199	67	57	6.7
Kwik Save	171	4	16.1	9.8
Netto	141	14	23.5	13.7
Safeway	200	119	31.0	4.3
Somerfield	194	46	100	6.3
Tesco	200	17	43.4	19.2

Source: CC calculations based on company data.

Note: Sainsbury was unable to supply this historic data.

7.121. Table 7.3 describes the distribution of the price indices for the sales-weighted basket over all products and the number of stores in which they occurred.²

¹These data are not used to compare the absolute level of prices between different stores of different supermarket chains, because there may be product specification or quality differences between their product lines.

²These stores were chosen according to the stratification method in Appendix 7.6; this is not a random sample.

TABLE 7.3 Distribution of sales-weighted price indices (from sample data)

Company	Price index (company average = 100)	Number of stores
Budgens	98.466	2
	99.550	29
	100.673	8
	101.152	8
	101.505	1
CWS	99.925	43
	100.461	7
Kwik Save	99.350	8
	100.037	2
	100.054	4
Netto	100.136	36
	0.9993	4
	0.9995	1
	1.0001	48
Safeway	99.476	19
	99.900	3
	100.140	25
	100.562	12
Somerfield	99.927	19
	99.934	2
	99.956	1
	100.014	10
	100.062	2
	100.067	10
	100.117	1
	100.131	4
Tesco*	99.128	28
	100.585	7
	100.815	25

Source: CC calculations based on company data.

*Tesco told us that a few of its stores were in transition from local to national pricing and so appear to fall between these two price baskets.

7.122. Table 7.2 shows that in general only a limited number of products are price flexed. In some cases these are very few. The average level of difference between the minimum and maximum prices for each product varies across companies from 4.3 to 19.2 per cent, although the price range for individual products can be very much more, with prices as much as doubling in some stores compared with others. However, Table 7.3 shows overall store price indices based on a sales-weighted basket. On this measure, the degree of price flexing is found to be very much lower. The reasons for this are that only some products have variable prices, and that in most cases it appears to be relatively low-selling lines that are price flexed. The important main line items are not price flexed.

7.123. Table 7.3 shows that the cost of a basket can vary under the same store fascia by up to 3.04 per cent between different Budgens stores, 0.54 per cent in CWS stores, 0.79 per cent in Kwik Save stores, 0.001 per cent in Netto stores, 1.09 per cent in Safeway stores, 0.20 per cent in Somerfield stores, and 1.69 per cent in Tesco stores.

7.124. Tesco provided us with details of the average price differential for its local basket between Local and National stores¹ between March 1999 and April 2000. This varied from 5.8 to 9.1 per cent. It also told us that the proportion of turnover in a local basket varied from 3.5 to 6.4 per cent, implying a difference in price for a representative customer of between 0.23 and 0.57 per cent. Based on the total turnover figures for all Tesco national pricing and local pricing stores, this implies that customers in local stores save between £10.5 million and £25.9 million a year over the prices charged in national stores.

¹These terms are explained in Appendices 7.1 and 7.5. A small number of products are categorized as being in the local basket. Some of these will carry lower prices in some stores (Local stores) than in the majority of stores (National stores).

Concerns on price flexing

7.125. Price flexing is potentially of interest for several reasons. First, price flexing may reflect the fact that shops are able to exploit local market power. If a store is the only one within a local catchment, or for some other reason is strong (for example, store size), it may be able to charge higher prices than if facing more active price competition from local competitors. Another possibility would be if the prices charged in certain smaller store formats were higher than was justified by cost, in order to exploit people's need for emergency and top-up shopping, when their ability to consider relative prices may be reduced.

7.126. A second possibility is that prices may be lowered only in the presence of particular competitors, for example low-cost ones. This may again be an indication of a competitive failure in areas without this competitor. It may also constitute predatory behaviour against that competitor, if a company is willing to suffer lower returns than would otherwise be the case in order to restrict the competitor's market share and its ability to grow.

7.127. Thirdly, regional patterns of pricing may be observed. This may reflect regional variations in costs, or regional variations in customer preferences and price elasticities, if multiples set optimal prices on a regional basis. Alternatively, it may reflect regional market power or the relatively greater presence or absence of particular competitors in particular regions.

7.128. The possibilities raised above show that price flexing could have the effect of restricting or distorting competition. It may also be viewed as discriminatory if pricing practices penalize certain parts of the population by requiring them to pay higher prices than otherwise because of the absence of particular competitors in their area. People who are least mobile are the most likely to be disadvantaged.

7.129. Against this, if some stores genuinely face higher costs, for example because of being in a distant and isolated location, then without some degree of price flexing, it may be that such stores would not be viable and some communities would not have access to any grocery shopping. If costs vary on a regional basis, then uniform pricing implicitly entails consumers in low-cost areas cross-subsidizing consumers in high-cost areas. This may imply a socially undesirable redistribution of income from low- to high-income areas (if low-cost areas coincide with low-income areas).

7.130. In the light of these considerations, two exercises were carried out. The first of these investigated how prices of an operator varied across particular stores according to local market conditions, store characteristics, location and local demographic factors, to see if local competition influenced pricing. Further exercises were employed to complement the investigations and address criticisms from the parties. The second approach used an econometric model of consumer choice to explain competitive behaviour. These exercises are described in turn (detailed in Appendices 7.7 and 7.8).

Models of price setting

Isochrone analysis of local price competition

7.131. The first method regressed a sales-weighted basket of prices for each store against measures of the store's own characteristics and competition variables. Data were collected for up to 60 stores for each party. Price indices were calculated for each store as described in paragraph 7.120. The set of variables used to describe each store is outlined in Appendix 7.6. These include store size and location, availability of supplementary facilities such as in-store counters and car parking, the age of the store, etc. Local demographic information was available to indicate rates of car ownership and average income levels in the postcode sectors around the store.

7.132. Competition was measured in terms of the competitors located within a given drive time of the store. The boundary of the area accessible within a given drive time is called an isochrone (discussed in Chapter 4). Competition variables were constructed from these covering:

- number of competitors;
- number of superstores;

- variables indicating whether there was a discounter present, whether there was an Asda or Morrison, and for other specific stores;
- the local market share of the company operating the store (as sales of reference goods relative to the total sales of reference goods by all identified stores);
- the market share of the predominant company (ie with the largest local market share); and
- various combinations of store identities to explore whether any particular duopolies allowed prices to be maintained at higher levels.

7.133. The details of the analysis are described in Appendices 7.6 and 7.7.

7.134. It did not always prove possible to obtain satisfactory results. The models for Budgens and Kwik Save were very poor, and did not add anything to the account of practices provided by the companies themselves. In the case of CWS, it was found that prices varied along with the size of the store in the manner that CWS had described. However, the results indicated that a store was more likely to be placed on a lower pricing tier despite its size if it was located in a northern region of England.

7.135. Safeway told us that throughout 1999 prices were varied in remote stores and town centre convenience stores, and where they faced a strong competitive threat, such as from an Asda or Morrison.¹ The modelling exercise largely confirmed its account. Significant downward pressure on price resulted from the proximity of an Asda or Morrison, and we also detected a noticeable effect from the presence of a discounter. As expected, large stores and superstores charged lower prices, but there also appeared to be a regional effect, in which higher prices were charged in London and the South-East. Demographic information did not provide any additional useful explanation.

7.136. Somerfield appeared to vary prices according to the presence of an Asda or Morrison store within the isochrone. There was also a size effect; larger stores were more likely to be placed on a lower price tier. There were also some signs that higher prices might be charged in older stores. This might be because operating costs were higher, or it might relate to the size of store. However, the explanatory ability of the model was poor.²

7.137. The initial analysis of the Tesco price data based on 60 stores suggested that pricing was based on a regional pattern and the average income level of the population within the store's isochrone. No competition-based variables were significant at 10- or 15-minute isochrones, and it appeared that the regional patterns did not reflect any greater likelihood of finding particular competitors in particular regions. However, it became evident in other work that there were some stores whose pricing did not reflect regional patterns, although none of these happened to be in the 60 stores selected for these studies. Therefore these 60 stores did not appear to be fully representative of Tesco's pricing practices. For example, 11 stores were identified on a lower pricing tier than others in the South-East. One was at Gravesend, two were at Eastbourne, seven were at Portsmouth and one at Banbury. Each of these stores was within close proximity of an Asda or Morrison store. However, there were also many other Tesco stores in the South-East, also close to an Asda or Morrison, that were not on the lower pricing tier.

7.138. Tesco told us that these pricing patterns were explained by exceptional consumer price sensitivity, and not regional factors or the presence or absence of competitors. It did acknowledge that price sensitivity could correlate with region and income, and that certain competitors were regionally distributed.³

7.139. It told us that 'where small price variations occur, on a limited range of products in specific stores, they are based on local market conditions. Specifically, Local stores operate in areas where customer price sensitivity is above-average'. It also said that this was the criterion used for its price flexing.

¹It later told us that the presence of any hypermarket could have resulted in its responding with lower prices (although these were often likely to be an Asda or Morrison due to the size of their stores).

²This does not mean the model was wrong; it may just reflect that some unmeasurable effects were also at work.

³Tesco was critical of our methodology, for example it argued that as Tesco stores were allocated to one of two price levels, a probit analysis was appropriate (although the price data provided indicated three price tiers).

7.140. We then asked Tesco for its complete list of store pricing levels and the corresponding data on consumer price sensitivity. The price sensitivity figures are derived from Claritas' National Shoppers' Survey. They are the proportion of customers living within 15 minutes of the store in question who said that price was 'very important'. We note that it is possible that these figures may themselves reflect local competitive conditions, for example relative price may be a more relevant consideration if there are low-price supermarkets locally. The plot of Tesco's store price levels against this local consumer price sensitivity data in Appendix 7.7 shows that there is no simple divide between lower-priced 'local' and higher-priced 'national' stores according to the consumer price sensitivity figures. Although there is a positive correlation between the two, there is also a large overlap and the most price-insensitive store is on the lower price tier. Consequently other factors must also be important.¹

7.141. Using the full list of Tesco's Local and National stores (but not Metro or Express stores), it is shown in Appendix 7.7 that regional distribution, and also proximity to Asda or Morrison stores, are statistically linked with price flexing. For example, 221 stores were on local pricing, and 247 were on national pricing. Regionally, no Tesco stores in London were on local pricing, while all in the North-East and Yorkshire/Humberside were on local pricing. In terms of competitors, 57.5 per cent of stores that were on local pricing had an Asda within a 10-minute drive time, while only 23.5 per cent of those on national pricing had an Asda within 10 minutes.

7.142. We used these data to conduct a further analysis of store pricing (see Appendix 7.7). The results suggest that consumer price sensitivity is an important factor in determining Tesco's local pricing. However, a number of other factors are also correlated and even allowing for local sensitivity and regional effects, the presence of Asda and Morrison stores is significantly correlated with lower prices. The effect could be observed separately at the 10-minute level but not at the 15-minute level. Tesco also seems more likely to raise prices in the South-East, East Anglia and the West Midlands, but to lower them in Scotland, after allowance for other factors. The results also suggest that prices are more likely to be higher, the greater the number of Sainsbury stores around.

7.143. Sainsbury was unable to provide us with the price data requested for this study. However, it provided a complete list of the stores that might selectively offer reduced prices, and these were analysed on the basis of regressions against specific competitors and regions. Results indicated that pricing varied with the size and fascia of store, region, and the presence of particular competitors. Prices were more likely to be reduced in the presence of an Asda store within a 15-minute drive time. Prices appeared less likely to be lowered in the presence of a Tesco or Safeway. There was no indication that prices rose in a situation where Sainsbury and Tesco had a duopoly.

Local competition and consumer choice

7.144. A separate exercise into local competition and consumer choice was undertaken and is described in full at Appendix 7.8. This study examines competition between multiples using information on consumers' behaviour. It examines prices, market concentration and consumer choice in a limited number of postcode areas in two regions of the UK. The first part of the exercise was a postcode sector-based analysis of pricing, and the second a model of consumer demand with applications to pricing issues.

7.145. In the first part, price indices and market shares were calculated for each main party in each of the 50 postal areas in the study.² Postal areas represent a convenient way of dividing the country into small areas. We examined whether differences in pricing across regions, for a given firm, were determined by the firm's market share, by the market share of any other player, such as a discounter, or Asda, or by overall market concentration. Regression models were run for each fascia that price flexes, considering the price index against own market share for primary trips, market concentration, market shares of the discounters, and of Asda, labour costs, store size and average household income.

7.146. The two regions considered cover around 10 million households. The first region (hereafter Region 1) is a large area from eastern Scotland to South Yorkshire. The second region (Region 2) is an

¹Tesco later said that in addition to the Claritas data, local management discretion and Clubcard data would also be used.

²A postal area is the geographic area covered by the first two letters of the postcode (or the first letter for very large cities). Only two regions were considered because of the costs of conducting the study and the burdens on the parties in providing the pricing data. The two regions were chosen to show a variety of market situations in the UK.

area comprising the South-East of England, western London, and south London. The areas are groupings of postal areas (ie areas covered by the first two letters of the postcode). The consumer choice data come from Claritas' National Shoppers' Survey where respondents are asked for the fascia of stores visited and expenditure on primary shopping per week, and on secondary shopping.

7.147. Pricing data are from a subset of around 100 products from those used in the isochrone-based analysis of local competition above. Prices were obtained for every reference store in these regions. Store characteristics data was obtained in the same way as the previous study.

Results

7.148. The first part of this study indicated for each company how prices tended to vary with the company's market share, and the presence of particular competitors. It was found that the combined market share of the three discounters was an apparent influence on the pricing of Kwik Save, Safeway and Tesco. Additionally, Asda's market share appeared to have an influence on Safeway and Tesco. No party appeared to set prices according to its own market share. For some parties, other factors such as store size and region were significant determinants of prices (see Appendix 7.8).

7.149. The second stage of the exercise was based on a full consumer demand model. This was used to find out to what extent store prices depended on local market share as opposed to cost differences. For the companies which varied their prices across stores, the store price index was regressed on the following variables: cost variables (region, store size, unit labour costs reported by company, format, and whether it is a town centre operation (by PPG6 code)), estimated profit margins (for clarification see Appendix 7.8), and the responsiveness of other company's sales to each store's prices.

7.150. The results again indicate that the presence of particular competitors can influence pricing. Budgens' and Tesco's results show an influence from the presence of the three discounters.¹ Tesco also appears to respond to the presence of Asda and Morrison, but the presence of a Sainsbury makes it less likely to reduce prices. Safeway also appears to be influenced by whether Asda and Morrison are close. However, its own local market share was now found to be significant for the pricing decisions of Budgens, the Co-ops, Kwik Save and Somerfield. Various parties were also influenced by factors such as store size, location and region.

7.151. Sainsbury was not analysed as it could not provide the store-specific pricing data.

Party comments

7.152. The parties' criticisms of the analyses are summarized in Appendix 7.8. In particular, they told us that postcode-based analyses were inappropriate as these did not match or take account of actual competitive areas. In general, however, this would tend to undermine identification of the effects observed, rather than to spuriously generate them. Also, the second stage of the study is not dependent on the postal area definition of local markets. The parties argued that the analyses could not distinguish between the effects of the presence of particular competitors, regional factors, and the importance of price to the local population. Tesco and Sainsbury both argued that as their pricing responded to the importance of price for local consumers, any correlation of price flexing with the presence of an Asda or Morrison was coincidental, probably because of the greater likelihood of finding these stores in low-income areas, and no causal relation was implied. Nonetheless, our concern is with the consequences of their local price setting rather than the cause of it. They pointed out that there were many exceptions to any pricing based on the presence of competitors.² Tesco denied any regional factor in its pricing decisions, and Sainsbury also argued that there were some estimation problems.

¹Budgens told us that the presence of discounters was not a factor in its pricing decisions.

²Tesco said that around one-third of its stores on national pricing had an Asda or Morrison nearby, and one-third of its local stores had no Asda or Morrison nearby.

Below-cost selling

Introduction

7.153. Our questionnaires revealed that nearly all the main parties sold a small number of products at prices below the cost of purchase, ie at a negative gross margin. Below-cost selling may distort competition if it is predatory in intent or effect. A possible consequence of this could be to force rival retailers out of business. We therefore asked the main parties to supply details of their relevant policy and practices, and we sought to quantify the extent and impact of below-cost selling.

7.154. We concentrated on negative gross margins. However, this understates the true degree of below-cost selling, because it ignores operating costs of distribution, labour, space and display costs, wastage etc, which will vary by product. Consequently some products will have a positive gross margin but negative net margin. We nonetheless concentrated on gross margins for two reasons: first, in most cases, the parties did not allocate operating costs or overheads to particular product lines, and so the required information was unavailable. Where such costs are allocated to product categories, this is considered in paragraphs 8.124 to 8.136. Secondly, a number of factors affect the level of gross margin making it difficult to identify a lower limit below which gross margins might be viewed as unfair or predatory, but negative gross margins would imply price unambiguously below-average cost.

7.155. When identifying instances of below-cost selling, allowance has to be made for discounts, overrides and similar payments that may have the effect of rendering an apparent case of below-cost selling profitable. However, it is often difficult to attribute particular supplier payments to specific periods or to particular product lines. As an example, an override payment could be negotiated over several products together on the basis of sales throughout the past year in total. Although we asked companies to provide information net of discounts, not all were able to resolve the problems mentioned above.

7.156. Similarly, below-cost selling may arise when multiples try to dispose of end-of-line stock (for example, if a product has been delisted, or to clear seasonal stock), and to clear products near their sell-by date. We considered that such distress purchases were by their nature short term and relatively unimportant, and therefore that any adverse consequences would be limited. There was some evidence that there could be a seasonal pattern to below-cost selling. Iceland said that Christmas turkeys were used as loss leaders to tempt people into stores. Some seasonal products were promoted below cost, such as suntan lotions. In general it was unusual for promotions to be run at a negative gross margin (as they usually had substantial supplier support), and by their nature such promotions are short term. Therefore, we concentrated on instances of persistent below-cost selling.

7.157. Excluding temporary below-cost selling, we were told that the main cause of negative gross margins was market pressure. This arises particularly where there is a commitment not to be beaten on price, and certain operators have a policy of maintaining a price differential with regard to particular competitors. For example, a discounter may have a policy of maintaining particular price differentials on certain lines, which may result in it selling below cost if rivals lower price too much. However, a major multiple may also have a policy of ensuring that its cheapest on display lines are not undercut. Other multiples may then have a policy of matching prices on budget lines with that major multiple. Indeed either the discounter or the major multiple may have a cost advantage that allows it to sell at low prices without below-cost selling, but which forces the other multiples to respond with below-cost selling. Asda told us: 'The focus of the discounters on limited lines has enabled them to deliver lower prices and has forced the national retailers to respond. This response primarily has taken the form of the introduction of budget ranges across almost all categories.' Consequently below-cost selling is most obvious on economy lines. Sainsbury sold many of its economy lines below cost (currently 38 out of 150). Somerfield's Basics lines showed the same pattern, as did Safeway's economy lines. Morrison reported that its Bettabuy budget range was designed to provide acceptable quality at rock-bottom prices—often sold at a gross margin loss. This raises the concern that the discounters may be adversely affected by this practice.

Company policies

7.158. Company policies on price setting as summarized in Appendix 7.1 show that circumstances exist under which below-cost selling behaviour may be generated.

7.159. Apart from budget own-label lines, nearly all the companies reported that they were also forced into persistent below-cost selling on a few high-profile KVIs, where they had a policy of reacting to or matching competitors' prices. Consequently, margins were squeezed, and some operators with higher costs, or even all of them, might be forced into below-cost selling on those products. Safeway said that market pricing nearly always applied to KVI-type products. Asda argued in its case that some high-profile brands might also be sold below cost because of market pricing, but it stressed that it was not focused on KVIs. Booth also claimed to be forced into below-cost selling occasionally on very visible brands such as Nescafé. Tesco, Morrison and Safeway's lists of products sold below cost also included occasional high-profile brands. Some commodity produce also appeared in these lists, such as some cuts of meat and, in particular, turkey portions. Asda said that below-cost selling could occasionally also result from its 'Rollback' programme, when suppliers initially declined to support the programme of lower prices or translate promotional support budgets into EDLP support, although prices might subsequently be renegotiated once volume growth had been demonstrated.

7.160. Appendix 7.1 shows the extent of below-cost selling for some of the major multiples. Tesco showed that although around 160 products might be sold below cost at any one time, only a small proportion of these were persistently sold below cost.

7.161. Only Lidl claimed that it did not sell below cost. Lidl's claim seems surprising given its relative price position and reactive policy. In addition, Budgens said that it would sell below cost only in extremely rare circumstances (one product was named) and its policy was not to operate below-cost promotions. M&S said that it did not generally sell below cost.

7.162. The smaller operators such as Booth, CWS, Iceland and Waitrose told us that they were against below-cost selling but were occasionally forced into it to compete.

Concerns on below-cost selling

7.163. There are two concerns over below-cost selling of groceries by reference stores. The first is that such practices may have a predatory impact on small and specialist retailers.

7.164. Supermarkets have a much broader offering than a small shop, and so are able in principle to cross-subsidize loss-making lines from their other sales to a much greater degree than a small retailer can. Some products may persistently be sold as loss-leaders as a competitive weapon. This may have a predatory motivation, but even if there is no such intent, small shops may be forced out of business by larger multiples from which they face competition because multiples have financial resources unavailable to independent traders. Alternatively it could be used to target particular retailers such as the hard discounters using budget own-label products, with the aim of restricting their growth and establishment as an alternative mainstream shopping channel.¹

7.165. Somerfield told us: '... in recent years some of our competitors have continually priced certain key lines at or below cost. For example, white bread and "cheapest-on-display" (COD) cans of tomatoes and beans. In our view, this is one reason why discount format retailers have been slow to gain market share'.

7.166. Predatory behaviour is often seen as a temporary tactic; when competitors are eliminated, the opportunity is taken to raise prices again in order to increase profits in the long term. However, in multi-product markets, predation can also be cross-subsidized through other products at the same time. For example, if a number of KVIs are priced below cost to get customers into a shop where they will also make other purchases, below-cost selling of these lines may continue indefinitely and overall be very profitable.

7.167. We did not find any evidence that multiples had engaged in short-term intertemporal predatory behaviour, ie supermarkets selectively lowering and then raising prices in response to the presence and subsequent exit of local competitors. There were, however, many examples of loss-making products effectively cross-subsidized by other lines. Whether or not below-cost pricing is predatory in

¹This issue has not been pursued as this market development was in the early to mid-1990s, and the discounters made no complaints on this issue.

intent, it can still have an adverse consequence on competition. It was suggested that this was one factor behind the decline in small and specialist retailers, though distinguishing this from the impact of consumer preferences for one-stop shopping is problematic. This decline is examined in Chapter 13.

7.168. The second concern is that below-cost selling generates incorrect price signals, distorting consumer choices. Such activity is allocatively inefficient as it leads to excessive resources being devoted to these products. We were told by some associations, such as the Federation of Bakers, that below-cost selling was a distortion of the market that had serious negative effects on the supply industry. (For example, it could lead to excessive focusing of consumer purchases on the product sold below cost, create inappropriate expectations among retailers and customers as to how much these and other products should normally cost, thereby reducing demand for the other products, and the elimination of some of the retailer and supplier base.)

7.169. Against these concerns, consumers benefit from cheap products. Given that such selling includes budget own-label lines and known KVIs, which are likely to be essential or basic products, it might be considered beneficial that such products are available very cheaply, particularly to low-income consumers, unless they then pay more for other lines as a consequence.

7.170. Legislation on below-cost selling exists in Ireland, Germany, France and Spain, and we were told that attempts to ban it had resulted in higher prices overall. A number of parties have drawn our attention to recent assessments of the Irish legislation that has been in force since 1987. The Irish Fair Trade Commission reported in 1991 that ‘... there was “persuasive evidence” that the prohibition of below cost selling had resulted in higher prices, a decrease in price competition and an increase in margins’ (paragraph 7.124 of the FTC report¹). Another report² found that a prohibition on below-cost selling did not seem to have any ‘profound effect’ on any of the market dynamics it was intended to influence (food prices, margins and trends in market structure).

Evidence on effects of below-cost selling

7.171. We have to consider whether there is evidence that small and specialist shops are adversely affected by below-cost selling. Supermarkets serve both the primary and secondary markets, but they cannot differentiate between these customers, and so their actions in the one-stop main shop market directly impact on the secondary market, and small, specialist and convenience shops. Small shops, particularly convenience stores, may be able to charge a higher price than supermarkets for top-up shopping because of the convenience factor. However, there is still likely to be a degree of price pressure from supermarkets. Small shops are much more dependent on the core products where below-cost selling is observed as a proportion of turnover than supermarkets, which have a much wider range and where losses can be cross-subsidized by other lines. Further, small shops are likely to have less advantageous supplier terms.

7.172. It is impossible directly to isolate and quantify any adverse impacts from below-cost selling, given the other factors that are at work. Therefore, we explored the impact of below-cost selling by employing some simulation analyses using actual profit and loss accounts.

7.173. Two formats of store were considered: large supermarkets and convenience stores. The simulation exercise was based on the actual cost, price and volume data for a particular grocery retailer. The approach was to see if price reductions on lines where below-cost selling is either evident or likely to result will have a greater proportionate impact on convenience stores than large supermarkets. Specifically, we considered how store contribution would be affected by price reductions, and particularly whether stores could be pushed into a loss-making situation. Convenience stores are in many cases able to charge a higher price, reflecting that customers value the convenience offered by proximity, and we have assumed that this price differential will be maintained.

7.174. Three hundred and seventy product lines were identified that were on sale in both large supermarkets and convenience stores, where gross margins were 5 per cent or less. While this does not directly equate to below-cost selling as defined above, it signifies the products where below-cost selling

¹*The Report of the Review of the Restrictive Practices (Groceries) Order 1987*, Fair Trade Commission, 1991.

²*Economic Impact of the 1987 Groceries Order*, a report commissioned by the Competition and Mergers Review Group (Republic of Ireland) and carried out by DKM Economic Consultants.

is likely to occur (and was observed on some of these lines).¹ Additionally, given that all other costs of the business have to be met out of gross margins, it seems extremely unlikely that any of these products were sold at prices that fully covered their total costs, ie negative net margins are likely. The lines were mainly frequently purchased KVIs, including a large proportion of high-profile branded KVIs and budget own-label offerings.

7.175. The 370 products accounted for 6 per cent of sales in the supermarkets, but 10.8 per cent of sales in the convenience stores. This is to be expected, as KVIs will feature heavily in secondary and tertiary shopping. The average contribution rate in the convenience stores (as a proportion of sales) was 0.4 per cent lower than in the supermarkets.

7.176. The lower contribution and greater proportion of sales dependent on low-margin lines means that small stores are more vulnerable to reductions in prices on these lines. The simulation suggests that a 10 per cent reduction in prices of the 370 lines in each of these store formats would result in a reduction in contribution in the supermarkets of 0.57 per cent, and in the convenience stores of 1.03 per cent. This alone would push 3.6 per cent of the convenience stores into a negative contribution, raising the threat of closure. Moreover, convenience stores' more restricted product ranges limit their opportunity to cross-subsidize these lines from sales or higher prices on other products.

7.177. There are a number of limitations in this simulation. First, the assumption has been made that the premium charged by a convenience store remains unchanged. However, their distinctive format may mean that they do not have to respond fully to supermarket price changes. That is, there may be only limited price competition between small stores and supermarkets in secondary markets. Smaller general mini-markets may have been rebranded as convenience stores in order to reduce the degree of price competition. On the other hand, price competition on KVIs may be so fierce that an increased price premium could not be maintained under the scenario of price cuts considered above. A potential loss of customers from small to large stores is also not modelled. Second, the analysis uses all sales in these stores. We have therefore had to include tobacco (a non-reference product) which often has low margins. Third, the analysis does not address the issue of specialist retailers, such as high street fishmongers and butchers.

7.178. Sainsbury and Tesco stressed that the number of lines where below-cost selling occurred was very small and so was unlikely to provide a significant effect in any event. It was said that competition was in the form of a basket of goods rather than line-by-line competition, and such products did not constitute a large proportion of total supermarket sales. If basket pricing is the basis of competition, then the impact of below-cost selling on individual lines is of less concern, as it is unlikely to have any significant predatory effect. Safeway told us that it did not believe small and specialist shops competed on price to any material degree, as consumers were willing to pay more for convenience, specialist ranges and so on. Sainsbury pointed out that below-cost selling often occurred on budget own-label lines which most small and independent shops did not stock. Asda questioned whether the list of products considered reflected what most convenience stores would sell, while Tesco argued that the basis of selection for these products was arbitrary. Tesco told us that below-cost selling was a competitive outcome, rather than a predatory tactic. We have no evidence to the contrary, but an adverse effect can still occur regardless of the cause. Asda and Tesco also pointed out that the separation of the groceries market into one-stop shopping and other types of shopping implied that there could be only a limited price effect of below-cost selling between supermarkets and convenience stores. Either the effect would be very small, or the separation of grocery retailing into primary (one-stop) and secondary markets was incorrect. We do not accept this. The distinction between primary and secondary markets is defined on the demand side with regard to the consumer's behaviour on that shopping trip, and not necessarily on the supplier side. The fact that one-stop shopping, in our judgement, constitutes a distinct market does not mean that below-cost prices of a number of products in the one-stop market can have no appreciable effect on small retailers selling a smaller range of products into a secondary market.

¹The simulation therefore illustrates the greater impact below-cost selling could have on smaller stores, but it does not establish the actual extent of this effect.

Price leadership

Introduction

7.179. Most of the supermarket groups said that their prices were primarily determined by the prices set by their competitors. Some mainly sought aggressively to lead price changes, but others were more explicitly reactive, often in relation to specific competitors. This may reflect intense competition, but may also lead to some price stability and higher prices than otherwise. If it is believed that any cut in prices will be matched by competitors, then the anticipated gains from a price cut will be short term and will be likely to be offset by lower margins in the long term. Consequently, prices may be expected to cluster around the going level. Price reductions will tend to occur only if a party believes it has a long-term cost advantage over its competitors. Conditions which facilitate such behaviour include: a small number of leading companies, with a competitive fringe of smaller players; possible barriers to entry; competitive interaction between the main players across a number of products or geographic markets; and the use of price guarantees. In such circumstances, product prices will tend to be similar or identical between different supermarkets, and price changes will tend to occur at similar times. Occasional price wars may then be more a device for punishing significant price reductions than an indicator of intense competition. Occasional price wars may also occur if cost structures or demand conditions facing the different players differ sufficiently to cause a break in ranks.

7.180. The emphasis on promotions as a means of providing price reductions is also consistent with price leadership. As noted previously, promotions typically provide the one means of gaining a price advantage which cannot easily be matched, because of the need to have pre-planned increased supplies. It could be that in the supermarket industry there may be a general acceptance, by all the players, of temporary price changes due to special promotions.

7.181. Against this background we undertook a study to investigate whether there was evidence of price leadership in the determination of prices for a number of product lines. In doing this we recognize that the existence of similar prices and price movements may also characterize intense competition, and that so-called 'barometric' price leadership may occur in which the price leader is in practice no more than the first operator to reflect new cost and demand conditions with a new price (see Appendix 7.9 for a summary of this and related concepts of price leadership).

Application to the UK grocery sector

7.182. The company pricing policies indicate that many price with regard to particular competitors, and in the case of budget own-label products, several parties all set their prices with regard to Tesco. If price leadership operates among the multiples then we should be able to discern that price changes tend to originate from one or two of the large companies and that other multiples tend to follow either very quickly or with a lag.

7.183. The analysis was designed to identify any pattern in the timing of price changes and, in particular, any signs of price leadership, where one or two multiples consistently act as leaders for price changes with other multiples following.

7.184. In order to examine this, all the main parties to the inquiry were asked to provide weekly price data for 18 products, over three years from September 1996 to September 1999. These products are listed in Appendix 7.10 with comments on the quality and processing of the data. The data requests proved difficult for many of the parties to meet, and there were inconsistencies over the treatment of promotions. However, our aim was to explore longer-term pricing behaviour rather than short-term promotional activity.

7.185. Our analysis concentrated on the five major parties: Asda, Morrison, Safeway, Sainsbury and Tesco, and one discounter, Aldi.

7.186. The approach taken was to relate the change in price of a product by each party to coincident and recent changes by the other parties. This procedure will identify frequent price leaders and allow the estimation of an average time lag between lead change and follower. First, we examined the data visually, graphing the time series of weekly price of each product in the six parties' supermarkets. This

allowed us to identify instances where a meaningful analysis could be undertaken. The patterns of price changes of each product are described in Appendix 7.11 with the aim of identifying supermarket chains that tend to systematically lead on price changes.

7.187. Identifying potential cases of price leadership purely by a visual examination faces certain problems. Several of the products selected are seasonal and their prices vary seasonally, including carrots, apples and lamb. Some other products were the subjects of frequent promotions, which made it difficult to identify more permanent price changes. In some of the products selected there were very few and only small price changes. Products where permanent price changes can be seen more clearly are white bread, milk, eggs, coffee and baked beans.

7.188. With data collected at weekly intervals price changes which take place within one week are recorded as being at the same time. If more than one supermarket chain changed price within one week, it is not possible to identify which one did so first.

7.189. Despite the above limitations some tentative conclusions emerge from the graphs. The multiple most often identified leading a price change is Tesco, with Asda leading almost as often. Few price changes originated in Safeway and even fewer in Sainsbury. Morrison's prices often did not change when the other major multiples changed theirs. Aldi's price changes seem quite independent of those in the major supermarket chains.

7.190. Some of Aldi's changes in the price of white bread, eggs and perhaps also milk preceded changes in the major multiples. However, the lag between the price change in Aldi and in the other multiples was very variable and sometimes quite long, at times as long as two or three months. It is doubtful therefore that this reflects price leadership, as we have defined it.

7.191. For a more robust approach, we used a regression-based analysis of prices of the potential follower multiple on the previous prices of potential lead multiples.

7.192. These regressions were estimated for the following items: bread, lettuce, carrots, milk, eggs, coffee, Kellogg's cornflakes and baked beans. These eight items were selected, from the 18 for which data on prices were available, because they had fewer price promotions and a visual examination of the data indicated a possibility of identifying a price leader. Regressions were carried out for the four main supermarket chains, Asda, Safeway, Sainsbury and Tesco. Aldi and Morrison were not included since the visual examination of the data showed clearly that their prices did not vary much and when they did it was rarely related to price changes in the other four multiples.

7.193. Asda and Tesco were tested as potential price leaders for all eight items. Others were tested for items where a visual examination indicated a possibility that they acted as price leaders but were never found to be statistically significant.

7.194. No significant price leadership was found for prices of bread or coffee. Price leadership was identified¹ in the other six items examined. Model results are reported in Appendix 7.12. The results were:

- (a) *Lettuce*: Tesco was a market leader for prices in the other three multiples. It led the prices in Asda and Sainsbury by about one week and those in Safeway by two weeks.
- (b) *Carrots*: Over the period examined both Asda and Tesco were leaders. Asda was a significant price leader for Tesco, with a one- and two-week lag, and Safeway with a week's lag. Sainsbury prices, however, were closely related, with a week's lag, to Tesco's prices.
- (c) *Milk*: There were few changes in the price of milk. The price of milk in Asda and Tesco was almost identical throughout the period and neither of them led the other. Both Asda and Tesco were significant price leaders of Safeway and Sainsbury with a lag of one week.
- (d) *Eggs*: There were few price changes in the price of eggs over the sample period. Tesco was a significant price leader for Sainsbury and Safeway, with one- and two-week lags, but not for Asda.

¹Measured at 5 per cent level of significance.

- (e) *Kellogg's cornflakes*: The only significant result was that Sainsbury followed prices in Asda and Tesco with a lag of one week.
- (f) *Baked beans*: Asda was the price leader affecting Tesco's price with a one-week lag and Sainsbury's and Safeway's prices with a lag of one and two weeks.

7.195. In conclusion, significant price leadership was identified for some items. Asda and Tesco were the price leaders in almost equal measure. However, significant price leadership was not found in 12 of the 18 products. This was either clear from the graphed data, or revealed by the regression analysis.

Asymmetry in price leadership

7.196. We then considered whether the data revealed any asymmetry in observed price leadership. That is, was it any more likely that a particular party would act as a price leader if prices were being raised than if they were being lowered or vice versa. This was explored by identifying the number of times when each party was the first in increasing prices and in reducing prices.

7.197. The results are presented in Table 7.4. Only Asda, Safeway, Sainsbury and Tesco were included in this analysis since the data provided by Aldi and Morrison had very few promotions, and they seemed to price independently of the other multiples.

TABLE 7.4 **Count of asymmetry in price leadership**

	<i>Asda</i>	<i>Safeway</i>	<i>Sainsbury</i>	<i>Tesco</i>
First price increase	8	7	4	19
First price decrease	19	3	3	15

Source: CC calculations.

7.198. The 78 observations are based on the price of the 18 items used to examine price leadership over the three years. They include only changes that were relatively significant, in terms of the relative price change. Seasonal changes and promotional changes are included where several multiples made price changes.

7.199. Table 7.4 illustrates the much greater extent to which Asda and Tesco initiated price changes than Safeway and Sainsbury. In the case of Tesco the price changes were fairly evenly distributed between price increases and decreases; for Asda around two-thirds were price reductions.

Price and cost changes, evidence of barometric price leadership

7.200. We then considered whether the data provided evidence of barometric price leadership. We obtained data on costs for the first 14 items listed in Appendix 7.10, Table 1. The change in price of three items was examined in relation to cost: milk, eggs and Kellogg's cornflakes. These items were selected because they were ones where permanent price changes could be identified and where some form of price leadership was also identified. If cost changes are the cause of price changes by the market leader, this may indicate barometric price leadership. The series are reviewed at the end of Appendix 7.11. It was found that price changes by the price leaders did not appear to correlate with changes in their costs. Therefore, we did not find evidence in support of barometric price leadership.

Company responses

7.201. Asda and Tesco commented that the models of price leadership had a very weak correlation. Most price movements were not explained by the price leader/follower relationships identified, but arose for other reasons. Sainsbury also noted that these models failed some diagnostic tests. Tesco argued that, a priori, leadership was unlikely to be found in this industry. There were too many product lines over which to coordinate pricing; there were regular strategy changes by major players; and the new products and services (for example, home delivery) meant that the market was too turbulent to tolerate stable price

leadership. Tesco pointed to the differing fortunes of different multiples over time as an indication of this. Sainsbury and Tesco also argued that if such behaviour constituted collusion it should be evidenced in excess profits, which were not evident.¹ Tesco also suggested that a multivariate approach would pick up the possibility that an apparent case of leadership between companies A and B merely reflected that party A was systematically quicker in responding to a third party's price changes than party B, when this third party was in fact the price leader.² Tesco also argued that as two price leaders were found, sometimes for the same product, it showed that there was no pattern of consistent leadership by any company, while Sainsbury argued that estimated coefficients over one³ suggested price responses greater than the leaders' price change, which was implausible.

7.202. Safeway told us that it would sometimes seek to take the lead in product pricing. It commented that in any event patterns of price leading and following were irrelevant, provided a process of competitive jockeying for position on pricing existed within the industry.

7.203. Sainsbury and Tesco each presented us with analyses that they had conducted of price leadership. These are summarized in Appendix 7.13. These exercises were intended to show that there was no consistent pattern of price leadership or following across a broad range of products. The Tesco evidence, based on 840 products across seven retailers, showed all parties changing prices independently of competitors. It found that each retailer led and followed each other retailer on a roughly similar proportion of products (about 20 per cent), and therefore it argued that there was no consistent pattern of leadership. Sainsbury analysed pricing data for 20 products over a seven-year period from Asda, Safeway and Tesco. For each product a single equation system was estimated where the level of prices was regressed on a time trend, and current and lagged Asda and Tesco prices. Sainsbury concluded that Asda and Tesco prices were often positively correlated with Sainsbury's prices (this was the case in 5 out of 20 cases for Asda and 8 out of 20 in Tesco's case), while lagged prices and the time trend were not significant. It said that the relationship with other multiples' prices was not stable and there was no indication of leadership over the medium to longer term.

Own-label pricing issues

Prices and margins

7.204. Companies were asked to explain their approach to margins on own-label lines as against branded product lines, and how own-label products fitted into their pricing strategies. The companies generally replied that their pricing strategies applied equally to branded and own-label products. However, some mentioned specific price targets relative to branded products as a further guide to price setting, although market pricing was still the dominant force, taking account of the prices of branded products and competing retailers' own-label prices, as well as any margin targets.

7.205. Asda estimated that its own label was usually 15 to 20 per cent cheaper than brands of the same quality. CWS said that there were no hard rules but typically own-label was priced 10 per cent less than branded products; similarly Sainsbury said that it aimed for its own-label products to average 10 per cent below the retail prices of popular branded equivalents.

7.206. Most companies agreed that higher margins could be obtained on own-label products because of lower costs. Somerfield told us that own-label would:

... invariably be purchased at a lower cost price. The reason for this ... is that own-brand products do not bear the marketing and sales costs that would be apportioned by manufacturers to branded lines ... (although) that thereby enables an own-brand product to be sold cheaper than its branded equivalent, there is no direct correlation between cost prices and retail prices. Retail pricing in both Somerfield and Kwik Save are determined by the price of that product or its nearest equivalent in the market place.

¹This, however, relies on the assumption that costs are as low as possible.

²However, we do not believe that there is such a relevant third party price leader that we have ignored.

³For example, Table 13 in Appendix 7.12.

Similarly Morrison stressed that own-label was a part of the overall product range, and was not protected. Therefore margins might be higher or lower. Tesco pointed out that as the own-label category included produce, there would be higher rates of wastage, which would reduce net margins for that category of products. Asda told us that overall margins on own-label products were not materially higher than that earned on branded products. Retailers did face some higher costs from own-label products that would normally be met by a branded supply. Examples included product development and testing, legal costs, marketing (for example, consumer research) and publicity, etc.

7.207. We were told that, with own-label lines being cheaper than branded equivalents, the margin in absolute terms on sales per unit could be less for own-label than branded products, but nonetheless give a higher percentage margin. If so, own-label purchases would only increase total profits if they stimulated further purchases.

7.208. The companies told us that there was a distinction between standard and budget own-label products. Companies would expect to earn a higher percentage margin on standard own-label than on branded lines, although that was not necessarily the case across all groups of products (for example, we were told that retail margins were very low on some canned products such as canned fish and canned tomatoes). However, in budget own-label products, the pricing policies of the multiples dictate that selling prices should not be higher than that of major competitors, and local price guarantees are often offered to that effect. Generally, this results in low percentage margins and, often, negative margins on budget own-label.

Issues on pricing

7.209. Assessment of issues relating to own-label pricing is complicated by the possibility of quality differences between retailers, and relative to branded products. We could not locate any existing work that allowed any general assessment of quality differences. In general we were given the impression that in the UK, most standard own-label products were viewed as of similar quality as branded products; the companies told us that they went to considerable lengths to ensure similar qualities, for example through blind tastings. Nonetheless we were unable to resolve this relative quality issue.

7.210. The distinctive issue that relates to the pricing of own-label products concern so-called 'umbrella pricing'. This describes a situation where the prices of some own-label products are specifically set relative to branded competitors. In this possible case, the price of the branded product effectively sets an upper limit for the pricing structure of the entire product group. Own-label product prices would be maintained at a given discount to their branded equivalent even though the lower costs of own-label might warrant lower prices. Both the supplier of the branded product and the multiple then have an incentive to maintain or even increase the price of the branded product in these circumstances. The price of the own-label products is below that of the branded product but still set above its competitive level. The multiple is then able to earn a higher margin on its own-label product under the 'umbrella' of branded product price levels.

7.211. This hypothesis contrasts with the parties' statements that own-label products supply competition to branded products, and that their existence strengthens negotiating power against a brand supplier to drive costs down. It also ignores price competition between retailers and effectively presupposes insufficient competition between them; however, own brands may be hard to compare across multiples because there is uncertainty as to quality differences. On this view, rather than branded products holding levels of pricing up, own-label products are a significant factor in keeping downward pressure on prices.

7.212. To determine the extent of the pass-through to retail prices of lower supplier margins we examined supplier and multiple cash margins on five 'standard' own-label products. This is detailed in Chapter 8. Our analysis indicated that on average, Asda, Sainsbury and Tesco passed through around two-thirds of their direct cost savings on own-label to consumers in the form of lower prices. Around one-third was kept in the form of higher cash margins. Morrison passed through nearly all its cost savings on these products to consumers, while Safeway passed through a third of its cost savings.

7.213. Given that there are costs, which the manufacturer bears in relation to branded products but the retailer bears in relation to own-label, we conclude that the occurrence of 'umbrella pricing' is not proven.

7.214. Issues relating to predatory pricing, particularly in relation to budget own-brands, are covered in paragraphs 7.153 to 7.178.

Transmission of supplier prices to retail prices

Introduction

7.215. This section examines the question of whether changes in costs are passed through to retail price changes fully, and in good time. This can throw light on the general issue of whether prices can be set without regard to cost. But it has also been suggested that multiples might have excessive buying power against suppliers, which could be used to reduce costs, with the resulting savings accruing to multiples' profits rather than to consumers. In particular, concern has been expressed that price cuts suffered by UK farmers in 1997 and 1998, notably in the livestock sector, have not been reflected in the retail prices charged in supermarkets. The National Farmers' Union said that farm-gate prices had fallen far behind the RPI for food and catering over the last ten years, and the Northern Ireland Agricultural Producers Association, Yorkshire Farmers' Livestock Marketing Limited and others highlighted such concerns in the livestock sector. Also Milk Marque told us that shop prices of milk had not fallen as much in absolute terms as the selling price of raw milk between winter 1996/97 and winter 1998/99.

7.216. Commenting on its 1997/98 performance in its strategic plan, Asda told us, '... the last financial year has seen an increase in gross margins, implying that we have not passed on the full benefit of improved terms to customers. That this was achieved without a substantial deterioration in our price position, suggests this has not been a purely Asda phenomenon, and it appears that this margin effect has been experienced across the industry...'. While Asda interpreted this as an indication that it should seek to further improve its price advantage, it also suggested that there was no automatic or consistent pattern of transmission between costs and prices.

7.217. If retail prices do not properly reflect the resource costs of production, then consumer choices and production patterns are distorted. It is impracticable for prices to be revised instantly in line with every cost change due to the administrative costs of price changes. Companies may seek to stabilize short-term price fluctuations, and some told us that cost savings might be used to reduce prices elsewhere in the shopping basket. They will also need to be aware of their competitive price positioning. Rigid cost-plus pricing is not therefore to be expected, but in the long term, in a competitive market, we would expect product prices to be broadly cost reflective.

7.218. Evidence has been submitted exploring the price pass-through issue in the context of meat products from Tesco (the London Economics Study), the MLC and MAFF. These studies are summarized in Chapter 11, as they are concerned with price links through the whole length of the food chain, rather than just pricing at the retail level, which is covered here. In broad terms, it was found that cost reductions at the farm-gate level had either been eventually passed through to retail prices, or were offset by cost increases elsewhere in the meat processing chain, which suggested that there was unlikely to be a failure of pass-through at the retail level. Sainsbury also told us that meat was one of its least profitable product categories. These studies all used measures of retail prices based on an average for the entire animal, rather than those cuts of meat actually sold by supermarkets. The cuts sold in supermarkets have changed over time; in particular they are now likely to sell a greater proportion of higher-quality cuts, other parts of the carcass going for other uses.

7.219. To complement this we examined how far and how fast changes in prices paid by multiples to their suppliers were reflected in retail prices. As our concern is with the behaviour of multiples, we focused on the extent of pass-through from their direct suppliers to retail prices. It is possible that multiples will push for cost savings from their suppliers, which will re-percuss up the supply chain to primary producers. But unless this shows up as an increased margin between direct supplier and multiple, such cost cutting will necessarily have been reflected in lower retail prices. Although gross margins are derived in this analysis, no judgement is made as to whether these are reasonable. The aim of this exercise is to show whether, in the case of these examples,¹ price changes reflect cost changes in the short to medium term.

¹However, it should be noted that we are covering only 14 out of 25,000+ lines in this exercise.

Data

7.220. All the main parties were asked to provide five years of national average retail prices and supplier costs for the first 14 products listed in Table 1 of Appendix 7.10. The products were chosen to represent products supplied by relatively weak suppliers (agricultural producers and bakers), with some branded or own-label processed goods as comparators, where suppliers may have greater negotiating strength. Lettuce and carrots are both sourced from the UK through most of the year, but no fruit could be found with the same characteristics, and a consistent variety of apples (Cox's) were not supplied continuously. These products are fairly commonly bought items, and so are likely to display competitive pricing, although we were told that some multiples would not consider some of these products, for example lettuce, to be KVIs.

7.221. We asked for the data to be adjusted for the value of price- and volume-based promotions, and for any supplier contributions to promotions, discounts, overrides or similar retrospective payments. Non-price-based promotions, such as link saves and bonus loyalty card points, were asked for separately. Many of the parties had great difficulty in meeting these requests. Many had not retained data for the full period, or formats and definitions had changed, and in nearly all cases details of promotions were not kept. As a result, it proved impossible to strip out the effect of promotions and this makes interpretation more difficult. The same applied to some supplier discounts, and others were impossible to allocate to particular product lines or particular times. In practice, we asked parties who had difficulty responding to provide the best information available, and to ignore supplier discounts where these would have been unknown to buyers at the time that they set prices. In addition, some product lines had been changed or discontinued over time. The difficulties of comparability between different companies (for example, different pack sizes or qualities) mean that inter-company comparisons of prices and costs are difficult to make with confidence.

7.222. Retail prices were regressed against supply costs to show how and when changes in costs were passed into changes in retail prices. Products supplied by agricultural producers were contrasted with well-known branded product suppliers to see if there was evidence of different behaviour. However, one possibility is that they seek to negotiate costs on the basis of their prices, and so price and cost may be simultaneously determined or causality may even partly run from prices to costs.

Results

7.223. The data on prices, costs and changes in them were first graphed; observations on the series and diagrams of typical price and cost movements are given in Appendix 7.14. Branded products tended to display little cost variability, and where costs did change these were often reflected almost immediately in retail prices. Promotional activity caused the greatest variation in their price and cost series; promotions tended to be matched at least partly by supplier contributions. There were some signs that particular multiples had chosen to cut margins at times, for example to run branded KVIs at very low margins, trading off lower costs against reduced promotional activity.

7.224. Regression analysis was not feasible for the branded products given the lack of cost variation, other than for promotional programmes, and for companies repositioning the pricing of their products. For nearly all combinations of products and retailers, in so far as it could be determined, price and cost changes appeared to be related.

7.225. There was greater variability in costs and prices for the eight primary products. These were very volatile for lamb and, in particular, chicken. The parties told us that this was due to promotional programmes offered on meat products. The visual examination reported in Appendix 7.11 shows that there appeared to be some cases where there was little or slow price pass-through, for own-label bread, eggs, milk and lamb.

7.226. The econometric analysis of these products, while subject to considerable estimation problems, suggested that there was rapid and fairly complete price pass-through for most products. Short-term lags (within five weeks) were found mostly to be sufficient and the graphs of prices and costs did not suggest a longer adjustment period. There were exceptions where no link between prices and costs could be established. The main one was milk where market pricing through much of this period did not respond to cost for some retailers, and only partially for others.

7.227. Safeway commented that as the study examined changes in prices in relation to costs, it may well be just picking up the volatility of prices in a competitive market. However, we aimed to concentrate only on the link of costs to prices. Some parties argued that the analysis was inappropriate in that with a basket- or category-based trading philosophy, cost savings on one line may be reinvested in other lines or in improving other services. This resulted partly from the administrative costs of changing prices, which meant that frequent reactions to cost were infeasible. We were told that parties might deliberately seek to smooth prices, for example from seasonal variations, to maintain price stability. Some of the parties also said that no generalized conclusions could be drawn from such a small sample. The parties' comments on particular products are covered in Appendix 7.14.

Price competition overall

7.228. The various sections above have addressed a number of pricing issues individually. The question then arises of how intense is price competition overall. A number of the features of the industry that have been considered above suggest that there has been a significant amount of price competition in the period in which we examined the industry.

7.229. We observe that real prices for groceries have been falling in recent years. We also see that practically all the main parties actively and carefully monitor their competitors' prices, and in most cases attempt to a greater or lesser degree to ensure, at least on some proportion of their lines, that they do not price out of line with their main competitors. Indeed, on certain lines, no major party wishes to be seen to be above anyone else, such that an equalization of prices across such multiples can occur for some time. This can extend to specific pledges not to be undercut.

7.230. We also observe that several of the parties have adopted an aggressive pricing policy, taking the lead in price reductions for some products. Currently, Asda, Morrison and Tesco appear to be adopting this policy. Given the matching behaviour described above, such price reductions then tend to spread through the industry. At the extreme, this can generate temporary price wars that drive prices on certain products to very low levels for a period, or in a few cases to persistent below-cost selling.

7.231. Other major multiples may at times also lead price reductions on particular products. More often, we see them selectively offering substantial temporary price cuts on particular products via promotions. This is a major competitive weapon for many multiples. We also see changing market shares for multiples, consumer disloyalty, and changes in corporate policy. These are all consistent with active price competition, and have been evident in the period in which we have examined the sector.

7.232. However, a number of features also give rise to doubts about the intensity of price competition. The competitive features described above appear mainly to arise on a limited number of lines. It is not clear as to the extent of price competition on background lines, where price monitoring is less likely to occur, and where multiples are also less likely to target competitors' prices (although there may be some diffusion of prices from monitored products through to background lines). If competition is focused on a limited range of products in this way, and if this range is common to different retailers, then price competition may be unduly restricted to these lines.

7.233. Many of the parties said that they could not afford to be beaten on price on certain core lines, and we have seen evidence of a tendency towards price equalization on some core lines. This may actually generate incentives to avoid price reductions in these lines as all parties anticipated that no long-term advantage could be gained from price cutting. In some cases, a market leader may develop who effectively sets price. This may channel price competition into promotions, because this is the only way to secure at least a temporary price advantage that cannot easily if at all be matched. Other evidence appears to contradict this picture. The price-leadership analysis did not identify any generally applicable pattern of price leadership within the industry.

7.234. Confining competition to a limited range of lines is more easily sustainable if customers are capable of recalling and acting only on a limited number of product prices. Undue emphasis on this limited range of prices, from which consumers infer overall price competitiveness, could be exacerbated by the actions of the parties if they seek to focus marketing, promotions and general price awareness on a limited range of products. Many companies run promotional programmes that have the effect of drawing attention to these items. Some companies told us that this was a deliberate policy to draw people into the

shops for a broader shopping trip, rather than to just cherry-pick special offers. Companies may therefore believe that special offers create a favourable overall price impression. In addition, the volatility of prices from promotions may mean that it may be difficult for customers to form an accurate impression of true long-term prices, and promotional prices may be difficult to understand.¹ The companies argued that there was no evidence that consumer perceptions were limited to a small number of products, or that promotions contributed to any 'fog'. Although some products were regularly promoted, promotions did extend across a wide range of lines. For example, Sainsbury told us that it offered over 8,500 separate promotions between March and July 1999, while Tesco said that it ran around 15,000 promotions between June 1998 and July 1999.

7.235. If competition is focused as outlined above, then margins could be pushed to low levels on some products, but remain much higher on others, a pattern which we have observed (see Chapter 8). This means that the pattern of individual prices may not correspond at all closely to cost levels, and that prices may not always respond to changing costs. However, the price pass-through studies suggested that in most cases there was a close and rapid link between cost changes and retail price changes.

7.236. Overall, a mutual understanding may arise that intense competition is unavoidable on certain well-known lines but can for the most part be more muted elsewhere, particularly if promotions can be used to focus competitive pressures while creating the impression of wide price competitiveness. Very low or even negative margins have to be accepted on certain lines, but can be and are compensated for by higher prices and margins elsewhere. If so, downward price pressure across the full range of products offered for sale in supermarkets is not an inevitable feature of the competitive structure of this industry, but rather relies upon the willingness of particular players to adopt more aggressive pricing policies, for example to expand market share, or to experiment with much more broadly-based price reduction strategies. Such policies can change. The main question is whether the structure of the industry is such as to make intense price competition unavoidable across the whole range of products, or whether it is at the discretion of the main operators.

¹For example, Angus Council reported that some special offers displayed were difficult for consumers to assess in terms of value for money, and the variety of price offers did not make it easy for consumers to compare prices within stores and between stores (see paragraph 15.433).