

7 Conclusions

The monopoly situation

7.1. Under the reference dated 9 April 1990 (made under sections 47(1), 49(1) and 50(1) of the Fair Trading Act 1973-`the Act') we are required to investigate and report on whether a monopoly situation exists in relation to the supply of soluble coffee within the United Kingdom for retail sale and, if so, by virtue of which provisions of section 6 of the Act that monopoly situation is to be taken to exist, and in favour of what person or persons that monopoly situation exists.

7.2. Section 6 of the Act is concerned with the supply of goods: a monopoly situation in relation to the supply of goods of any description in the United Kingdom can be found under section 6(1)(a) when at least one-quarter of the supply is by or to the same person.

7.3. As noted in paragraph 2.35, in 1989 The Nestlé Company Ltd (Nestlé) supplied some 48 per cent of the volume and 56 per cent of the value of soluble coffee for retail sale, and we have no reason to believe that the situation is significantly different at the time of our report. We therefore conclude that a monopoly situation exists in relation to the supply of soluble coffee within the United Kingdom for retail sale by virtue of section 6(1)(a) of the Act. We also conclude that this monopoly situation exists in favour of Nestlé. We have investigated the position as to supply by other undertakings but have not found any other monopoly situation to exist (see paragraph 2.35).

7.4. In accordance with our terms of reference we have therefore to consider:

- (a) whether any steps (by way of uncompetitive practices or otherwise) are being taken by Nestlé for the purpose of exploiting or maintaining the monopoly situation and, if so, by what uncompetitive practices or in what other way;
- (b) whether any action or omission on the part of Nestlé is attributable to the existence of the monopoly situation, and if so, what action or omission and in what way it is attributable; and
- (c) whether any facts found in pursuance of our investigation operate, or may be expected to operate, against the public interest.

7.5. In announcing the reference (see Appendix 1.1), the Director General of Fair Trading said in particular that the evidence on the relationship between changes in the price of coffee beans and of the finished product and on profitability suggested that price competition in this market was not as effective as it might be.

The supply of soluble coffee for retail sale

7.6. We have defined the supply of soluble coffee for retail sale within the United Kingdom as supply by manufacturers located in the United Kingdom, and by importers. In 1989 about 39,000 tonnes of soluble coffee, worth almost £500 million at manufacturers' prices, were supplied for retail sale in the United Kingdom. The estimated market shares of suppliers by volume and by value are summarised in Table 7.1.

TABLE 7.1 Market shares of suppliers of soluble coffee for retail sale, 1989

	<i>per cent</i>	
	<i>Volume</i>	<i>Value</i>
Nestlé	47.5	56.0
GFL (and associated companies)	24.9	24.7
Lyons Tetley	12.8	8.3
Brooke Bond	5.7	5.7
Other suppliers	<u>9.2</u>	<u>5.2</u>
	100.0	100.0

Source: See Table 2.3.

7.7. Soluble coffee is supplied both under the brand name of the manufacturer or importer and also to retailers and wholesalers for sale under their own brand name (which we refer to as 'own-label' coffee). The extent to which own-label coffee is supplied to retailers and wholesalers varies by manufacturer. Nestlé's policy is not to supply own label, hence the share of Nestlé's brands in the total market is as indicated in Table 7.1; similarly, Brooke Bond imports soluble coffee for sale only under its own brand names. Almost three-quarters of GFL's production of soluble coffee is sold under brand names, and the share of these brands in the market is about 18 per cent by volume. Almost all Lyons Tetley soluble coffee is supplied for sale as own label. In total, own label accounts for about one-quarter of the market by volume, less than one-fifth by value.

7.8. Nestlé's market share has increased by about ten percentage points since 1980, mainly at the expense of distributors' own-label coffees whose share of the market has declined by broadly the same amount over the period.

The market for soluble coffee

7.9. It was suggested to us that soluble coffee should be seen as part of a wider market including roast and ground (R&G) coffee, or alternatively of a still wider market including also tea and soft drinks. There may be some substitutability, particularly between soluble coffee and R&G coffee, tastes varying between different national markets. R&G coffee, for example, accounts for the bulk of coffee consumption in continental Europe, but less than 10 per cent of coffee consumption in the United Kingdom. Advertising may also help to shift demand over time between soluble coffee and other products.

7.10. However, it was generally agreed that there was little cross-price elasticity between soluble coffee and other such products. The cost of soluble coffee, at 2p to 3p per drink or 3p to 4p including milk and sugar, is somewhat more expensive than the cost of tea but considerably cheaper than many other drinks, particularly canned drinks such as cola, which can be over five times as expensive as soluble coffee. We would not therefore regard competition from other such products as likely to be effective in constraining the price that can be charged for soluble coffee, or the profits that can be earned on the sale of soluble coffee. We therefore believe that for the purpose of our inquiry, we should concentrate only on competition between suppliers of soluble coffee.

7.11. There are at least a dozen such suppliers. Most of the main suppliers each produce a range of their own branded products (for example, freeze-dried, and spray-dried granulated and powder, each of which may also be available decaffeinated), and many also produce own-label products for retailers. We are aware of over 30 retailers or wholesalers that sell own-label coffees, and most of them offer a range of freeze-dried, granule and powder coffees, the specification for which varies between retailers, even though several retailers may purchase from the same supplier.

7.12. In all, well over 200 types of soluble coffee are currently available in the United Kingdom. However, the bulk is sold in the major supermarkets where the consumer will typically be offered a choice of between 33 and 38 types of coffee (with slightly less choice being offered in the smaller branches of such outlets). That choice may include eight or nine types of coffee from Nestlé and GFL, nine types of distributors' own brands, three or four Brooke Bond types and between two and nine other branded types from smaller suppliers.

The main suppliers of soluble coffee for retail

7.13. *The Nestlé Company Ltd* (Nestlé) is by far the largest supplier in the United Kingdom. Its ultimate parent is Nestlé SA incorporated in Switzerland. It told us that the Nestlé group is the world's largest food manufacturer with food sales of £17.6 billion in 1989. Nestlé's turnover in 1989 was £878 million, of which sales of soluble coffee for retail in the United Kingdom amounted to £276 million.

7.14. Nestlé's main soluble coffee brands are Nescafé (a spray-dried, granulated coffee), Gold Blend and Blend 37 (freeze-dried coffees), Fine Blend (a spray-dried powder coffee) and two freeze-dried 'super premium' brands, Alta Rica and Cap Colombie. Nescafé is the leading brand in the soluble coffee market, accounting for some 38 per cent of the market by volume, standard Nescafé alone (excluding the decaffeinated version) accounting for 36 per cent of the total market. Freeze-dried and spray-dried soluble coffee is manufactured at Nestlé's factory at Hayes, the only plant for freeze-drying coffee in the United Kingdom; and spray-dried soluble coffee is also manufactured at Nestlé's other factory in the United Kingdom at Tutbury. The 'super premium' brands are imported from a Nestlé group factory in France. All of Nestlé's pure soluble coffee brands are supplied under the generic 'Nescafé' name; Nestlé believes that this gives it the advantage of an overall branding with cross-benefits between the particular products.

7.15. *General Foods Ltd* (GFL) and its associated companies account for the second largest market share. GFL is a subsidiary of General Foods Corporation (GFC), and its ultimate parent company is Philip Morris Companies Inc (Philip Morris), GFC and Philip Morris both being incorporated in the United States. In 1989 food sales of the Philip Morris group amounted to £14.2 billion. GFL's turnover in 1989 was £283 million of which sales of soluble coffee for retail amounted to £121 million.

7.16. GFL manufactures spray-dried soluble coffee at its Banbury plant. GFL's main brands of soluble coffee are Maxwell House (spray-dried, both granular and powder), Kenco (freeze-dried), Cafe Hag (decaffeinated freeze-dried and spray-dried granules), and Mellow Birds (spray-dried powder). Of these, Maxwell House is the second most popular brand in the market, with a 9 per cent share by volume. Unlike Nescafé, GFL uses a portfolio of brand names. It also supplies a number of own-label spray-dried granular and powder coffees.

7.17. Various other companies within the Philip Morris group are concerned with the supply of coffee in the United Kingdom but in examining profitability we have concentrated on GFL alone. Kraft General Foods Ltd (KGF) has since 3 December 1989, the beginning of the group's financial year, acted as agent for GFL in the marketing of that coffee in Great Britain. Northern Ireland is supplied through Kraft General Foods (Ireland) Ltd. A further associated company, HAG GF AG (HAG) manufactures freeze-dried coffee in Germany which it supplies to GFL for marketing under the Kenco brand name. HAG also supplies freeze-dried coffee to one major retailer for sale as its own label. During the course of our inquiry Philip Morris acquired control of the Swiss company, Jacobs Suchard SA (Jacobs Suchard), which also supplies own-label soluble coffee and soluble coffee to a distributor for sale under the Percol brand name in the United Kingdom.

7.18. *Lyons Tetley Ltd* (Lyons Tetley) and *Sol-Tenco Ltd* (Sol-Tenco) are subsidiaries of J Lyons & Co Ltd, the holding company for the food division of Allied-Lyons PLC (Allied-Lyons). Until recently, Lyons Tetley supplied R&G coffee and Sol-Tenco supplied soluble coffee, but in January 1990 the two businesses were combined within Lyons Tetley. Food sales of Allied-Lyons were some £1.2 billion in the year to March 1990, and sales of soluble coffee were £46 million of which about 65 per cent by volume consisted of sales for retail in the United Kingdom, all for own label. The balance represented sales for other purposes such as exports and bulk catering. Soluble coffee manufacture takes place at a plant in Greenford.

7.19. *Brooke Bond Foods Ltd* (Brooke Bond) is a subsidiary of Unilever PLC. Total sales of Brooke Bond in 1989 were some £365 million, of which sales of soluble coffee in the United Kingdom amounted to some £27 million. Brooke Bond acquires its supplies of soluble coffee mainly from Brazil and Germany, with packing plants at Redbourn and Trafford Park. Its main brands are Red Mountain (freeze-dried), Café Mountain (granular), and Brazilian Choice (powder).

7.20. Other significant suppliers to the United Kingdom market are S Daniels PLC, Douwe Egberts UK Ltd (Douwe Egberts), Fine Foods International Ltd, Food Brands Group, Gold Crown Foods Ltd and McCormick (UK) PLC. Of these, Douwe Egberts is part of the Sara Lee Corporation of the United States, and a main supplier of R&G coffee elsewhere in Europe. These suppliers together account for about 8 per cent of the market by volume. Some major retail chains also import directly into the United Kingdom, and there are a number of smaller importers.

Profitability

7.21. It was partly concern about the profitability of the supply of soluble coffee which led to our inquiry. Details of the profitability of the main suppliers are more fully set out in Chapter 4, where we summarise statements of their soluble coffee sales, costs and profits (based on statements submitted by them, and derived from their accounting records) and compare certain financial ratios. There are inevitably differences between their accounting policies (see paragraph 4.39) which to some extent affect comparisons, but we do not believe that these are sufficiently material to invalidate the broad conclusions that can be drawn.

7.22. Nestlé, as well as being the leading supplier in the market, is also by far the most profitable supplier, with a return on tangible capital employed on the sale of soluble coffee for retail of 114 per cent in 1989, measured in accordance with the accounting principles used in preparing its management accounts. Its leading brand, Nescafé, accounted in 1989 for over 85 per cent of Nestlé's profits in soluble coffee, with standard Nescafé alone (excluding the decaffeinated version) accounting for more than 80 per cent.

7.23. The other main suppliers to the market are less profitable. GFL, the second largest supplier, had a return on capital employed on sales of reference products of some 29 per cent (before royalties) in 1989. Sol-Tenco's return on capital employed on soluble coffee (including the effect of some non-reference soluble coffee sales, as explained in paragraph 7.18) is estimated at 10 per cent in the year to March 1990, and Brooke Bond's at about 9 per cent and 3 per cent in 1988 and 1989 respectively.

7.24. The profitability of Nestlé is significantly higher than that of the other three main suppliers, of industry generally (which showed a 19 per cent return on capital employed in 1989), and of the food, drink and tobacco manufacturing sector in particular (which showed a 17 per cent return on capital employed in 1989). As shown in Table 4.37, Nestlé's higher profits per tonne of soluble coffee in 1989 resulted mainly from higher sales revenue per tonne than for the three other main suppliers, lower coffee costs per tonne than for two of the other suppliers, and lower advertising costs per tonne than for the other two suppliers of branded coffee (Sol-Tenco does not incur advertising expenditure).

Trends in profitability

7.25. Nestlé's profitability has increased significantly since 1985, when its soluble coffee return on capital employed was about 50 per cent. Profit per tonne also increased over this period, by about 70 per cent relative to the Retail Price Index (RPI) (from about £2,900 to £5,000 per tonne, or from 29p to 50p per 100 grammes, at 1989 prices). This increase in profitability of Nestlé's coffee sales resulted from a number of factors. In particular, there was a considerable reduction in the coffee cost per tonne (by £3,500 at 1989 prices, almost 50 per cent compared with the RPI). This reflected a reduction in the world prices of green coffee beans, notably since the summer of 1989 with the breakdown of the International Coffee Agreement, which had been instituted to stabilise prices. Nestlé's coffee costs have also been affected by higher yields in use of coffee beans, and changes in the blend of beans.

7.26. Nestlé's reduction in coffee costs was partly offset by a reduction in its revenue per tonne of coffee sold (by £1,400, at 1989 prices, or less than 10 per cent compared to RPI); and by an increase in media advertising and other promotion costs (by about £500 at 1989 prices). The resulting increase in net operating profit was accompanied by a reduction in tangible capital employed in soluble coffee activities of about one-quarter in real terms over this period.

7.27. Nestlé estimates that in 1990 there will be a slight reduction in its operating profits, revenue per tonne of soluble coffee sold being reduced by more than the fall in coffee and other costs per tonne. However, as its capital employed will also be lower, its return on capital employed on soluble coffee will increase from 114 per cent in 1989 to 124 per cent in 1990. Nestlé's profitability is further discussed in paragraphs 7.53 to 7.62.

7.28. Between 1985 and 1989, GFL's profit per tonne (after interest, but before royalties) declined by about 15 per cent, relative to the RPI (from about £1,300 to £1,100 per tonne, at 1989 prices). There was a significant reduction in GFL's coffee cost per tonne (by about £3,200, over 40 per cent compared with RPI). This was partly offset by a reduction in the revenue per tonne of coffee sold (by about £1,600 at 1989 prices, a little over 10 per cent compared with the RPI); and an increase in media advertising and other promotion costs (by about £1,600 at 1989 prices). These figures are, however, partly dependent on the precise treatment adopted for trade allowances (see paragraph 4.22(a)); on the basis of the treatment of trade allowances preferred by GFL, the reduction in revenue would be somewhat greater, and the increase in media advertising and promotion costs somewhat less than these figures suggest.

7.29. Sol-Tenco's profitability also declined over the period, and Brooke Bond made losses in every year except for 1988.

Retail prices

7.30. Our terms of reference refer to the supply of soluble coffee for retail sale, ie to retailers. In considering competition at this wholesale level, it is necessary, however, to have regard also to the effects of competition at the retail level, ie on sales by the retailer to the ultimate consumer.

7.31. Competition between suppliers has been described to us as being on the basis of 'value for money' rather than price alone. The price of supplies for retail depends in part on the position in the retail market sought by each supplier, and the margins added by retailers. Price differences between suppliers (and between products of the same supplier) therefore to some extent reflect consumers' perception of the differences in quality between particular products.

7.32. Nestlé's pricing policy has been to 'add value' to its products, rather than to reduce prices in line with its costs. Retail prices of Nescafé, its leading brand, averaged some 139p per 100 gramme jar in the five main multiple stores in June 1990, some 5p above Maxwell House, the second most popular brand in the market. Over the last four years, the price of Nescafé has averaged about 4p above that of Maxwell House in multiple stores, but this differential has varied in individual months between 1p and 13p, and has tended to increase over time (see Figure 2.10). Evidence we have seen suggests that the quality of Nestlé is regarded as better than Maxwell House. Red Mountain, the main Brooke Bond brand, was formerly priced at a discount to Nescafé but is now priced at about 20p above Nescafé, reflecting an intention to reposition Red Mountain in the market at the risk of some loss of market share, which has in fact taken place.

7.33. Retail prices of own-label products are generally at a more substantial discount to Nescafé. The information we have seen suggests that the multiples' own-label granulated coffees averaged some 29p below the price of Nescafé over the last four years, but varying in particular months from 21p to 36p below Nescafé prices. Own-label powder coffees averaged some 60p below the price of Nescafé over the last four years as a whole, while mixtures (of coffee and chicory) averaged some 88p below the price of Nescafé over the last four years. There is at present also wide variation between own-label prices, according to consumers' perception of the quality of the products. There is therefore a wide spectrum of prices, ranging in five main multiple stores from about 50p for coffee-chicory mixtures to £2.55 for Nestlé's 'super premium' brands Cap Colombie and Alta Rica, reflecting a variety of quality, with Nestlé generally offering consumers a higher perceived quality, for a higher price.

Quality and advertising

7.34. Competition between suppliers also takes the form of quality improvement and advertising. The main suppliers monitor consumers' perception of differences in the quality of both their own and their competitors' soluble coffee brands. GFL in particular is improving the perceived quality of its products to become more competitive with Nescafé. The declining share of retailers' own-label coffees has been attributed to their previous relatively lower quality, but we were told that the quality of own-label coffee was also being improved to increase market share, and some retailers now believed their own-label coffees to be much closer in quality to those of Nestlé or GFL. Low priced, lower quality own-label coffee continues, however, to be available.

7.35. Nestlé's market position would also appear to reflect the effectiveness of its advertising expenditure. Nestlé's advertising and promotion costs, at about 13 per cent of revenue in recent years, are not dissimilar to those of branded products in other markets: but less, as a percentage of revenue, than those of GFL and Brooke Bond, its main competitors in soluble coffee. Information we have seen suggests that Nescafé has developed into one of the most successful grocery brands. The strength of the Nescafé brand, along with its sustained quality, accounts for Nescafé's leading position in the market.

Manufacturers' prices

7.36. There is very limited variation between retailers in the prices they charge for particular major brands: in June 1990, for example, all five major multiple supermarkets charged £1.39 per 100 grammes for Nescafé, although we are aware of two other multiple stores charging £1.37. There is a slightly greater variation in Gold Blend prices, four of the five major retailers charging £1.69 and the fifth £1.67, and we are aware of one other multiple store charging £1.75. The general view of both retailers and manufacturers was that, as 'known value items', there was little scope for variation between retailers in the prices of leading brands, particularly Nescafé. Both manufacturers and retailers to whom we spoke said that retail prices were entirely a decision for the retailer, and that suppliers did not attempt to impose any particular retail price.

7.37. As discussed in paragraph 2.71, retail margins on the main Nestlé brands, in particular Nescafé, are considerably below those on other branded coffees, and are even further below those on own-label coffee. Retail margins, for example, are estimated at about 10 per cent of purchase price on Nescafé and Gold Blend, more than 15 per cent on Maxwell House and Kenco, over 20 per cent on typical own-label coffees and as much as 40 per cent on some of the cheapest brands of coffees. It was suggested to us that this was a typical pattern of margins for the grocery trade, the lower margins reflecting in part the greater competition between retailers in pricing of 'known value items' and in part the faster stockturn of the brand leader.

7.38. As a result of the lower retail margins on Nescafé, the differences in the manufacturers' prices of competing brands are considerably greater than the differences in their retail prices at which they are sold to consumers. The average realised manufacturer's price of Maxwell House in 1989, for example, was some 17p per 100 grammes below that of Nescafé, while the main own-label prices to retailers were over 60p below the manufacturer's realised prices of Nescafé. Retailers' margins on Gold Blend, Nestlé's second most successful product, are also below those of the other freeze-dried coffees, and the differences in manufacturers' prices of freeze-dried coffees are not fully reflected in retail prices. The retail price of Kenco in 1989, for example, was slightly above that of Gold Blend (although it is now similar), while the manufacturer's price of Kenco averaged some 11p below that of Gold Blend in 1989.

7.39. Manufacturers' prices are arrived at by reference to trade list prices, published by the manufacturer, less discounts and rebates, which are individually negotiated with the retailer. The retail margin on Nescafé arises largely from these discounts and rebates, and changes in retail prices of Nescafé primarily reflect changes in list prices.

7.40. As shown in Table 2.12, except for the price reductions in January 1990-which were greater on Nescafé than on Maxwell House-list prices for the two main brands, Nescafé and Maxwell House, have moved identically over the last five years. Both Nestlé and GFL told us that there was no discussion of these list price changes, but GFL appears to have reacted to the list price changes announced by Nestlé.

Nestlé indeed suggested that it was not unusual for firms in the grocery trade to follow price changes by the brand leader when adjusting their own prices to reflect changes in costs. There has, however, been a less close relationship in the realised prices received by the manufacturers, the extent of discounts from list prices varying between manufacturers and, for particular manufacturers, over time.

Adjustment of manufacturers' prices to changes in the world prices of coffee beans

7.41. As mentioned in paragraph 7.5, a further main concern which led to this reference arose from the relationship between changes in the prices of coffee beans and of the finished product. The cost of coffee beans is the largest cost element in the production of soluble coffee, accounting in the case of Nestlé, for example, for 57 per cent of operating costs in 1985, 40 per cent of costs in 1989. Coffee costs represent, however, a declining proportion of manufacturers' realised prices-Nestlé's coffee costs, for example, representing some 45 per cent of Nestlé's sales revenue in 1985, 26 per cent in 1989.

7.42. There have been a number of list price adjustments during the last five years. Soluble coffee prices were increased in January and March 1986, following the increases in green bean prices in the previous November and December. Nestlé told us that in this case it decided to anticipate increases in its costs, and increase prices in small steps to avoid the need for a single larger price increase; the actual price increases, it told us, did not fully recover the increases in its coffee bean costs.

7.43. Reductions in wholesale prices in March 1987 followed a steady reduction in coffee bean prices between the previous October and January. Nestlé told us that given the movements in coffee bean prices that had taken place, there was a risk that competitors would reduce prices by more. The retail prices of distributors' own-label coffees did indeed fall by 10 per cent more than Nescafé prices, but without Nescafé losing market share, which was attributed by Nestlé to its better quality.

7.44. The increase in Nestlé's prices in March 1989 was the only one of the changes not triggered by a major change in the market price of coffee beans. Rather, we were told, it was triggered by the belief that competitors would be facing inflationary pressures on costs similar to those foreseen in Nestlé's own budget. In the event, Nestlé's total costs in 1989 were broadly unchanged, compared with 1988.

7.45. The most recent sharp reduction in the price of green coffee beans occurred between the end of May and the beginning of August 1989. Manufacturers' and retail prices of some own-label coffees were reduced during August 1989, but a reduction in Nestlé prices did not take effect until January 1990. Nestlé told us that it was almost six months before the cost of finished goods sold by the company was affected by the fall in coffee prices at which time, in the run-up to Christmas, price adjustments were not practicable.

7.46. The resulting relationship between list prices for Nescafé, the leading brand, and the price of green coffee beans (showing also the effect of a six-month lag before coffee bean prices would be reflected in Nestlé's costs) is summarised in Figure 2.6. This shows that, at out-turn prices, Nescafé list prices are broadly at the level of 1985, despite a significant fall in the price of coffee beans. Figures 2.7 and 2.8 confirm that the recent fall in green bean prices has clearly coincided with an increase in both the manufacturer's contribution and the retailers' margin on Nescafé relative to RPI, although the manufacturer's contribution is expected to decline in 1990. The increase in Nestlé's profitability is also apparent from the figures in paragraph 7.25.

Barriers to entry

7.47. We are aware of over a dozen new brands that have been introduced to the United Kingdom market over the last two years or so, including new products by Brooke Bond and GFL, already established in the market, and also a number of brands from Food Brands, a new entrant which obtained supplies from Jacobs Suchard, and from Douwe Egberts which has recently sought national distribution of its products in the United Kingdom. Recent entry by new suppliers has, therefore, been based on soluble coffee imported into the United Kingdom. There has also been a significant expansion of own-label coffees available.

7.48. The ease of entry into the industry depends on the method of entry adopted. Coffee manufacturers estimated the costs of establishing a new plant at £30 million to £50 million for a plant producing powder or granules, or £35 million to £60 million for a plant providing freeze-dried coffee although these figures would be less if a plant was constructed at an existing food manufacturing site. We have received a variety of views on whether there would be economies of scale in establishing such a plant. Nestlé suggested that its preferred size for a plant producing the spray-dried product would be one with a capacity of 5,000 tonnes per annum, equivalent to over 10 per cent of the market.

7.49. It was suggested to us that a more likely means of entry would be to import soluble coffee from overseas and this is indeed the main method of entry that has occurred to date. Most of the evidence we have received suggests that supply of spray-dried soluble coffee is plentiful and that adequate quality can be obtained, particularly from South America, although it may cost more than coffee produced in the United Kingdom. There are fewer but adequate sources of freeze-dried coffee, and several brands have been introduced to the United Kingdom market during the last year.

7.50. A firm wishing to market a branded product would also have to incur advertising costs, which we were told may be £5 million for a national launch; this is not out of line with other branded grocery products. Advertising costs would, however, be less for entry into more limited local or regional markets or for entry into more selected 'niche' markets, with, for example, higher quality, higher priced products, which would not necessarily require television advertising. As well as requiring a new product to be adequately promoted, retailers may also demand a larger margin than on established brands, as an incentive to stock it. An alternative form of entry would be to supply own-label products to retailers; this would avoid the need to incur advertising costs, but the supplier would need to offer higher retailers' margins, and would therefore receive lower prices from the retailer.

7.51. In our view, therefore, there are several means of entry to the market. Entry has indeed occurred, and, although new entrants may be reluctant to compete directly with Nestlé for a large market share, there is no evidence that entry has been deterred by Nestlé's strong position in the market, or that Nestlé has taken action to prevent such entry.

The public interest issues

7.52. The central issue of our inquiry is whether the profits and prices of Nestlé, the scale monopolist, result from its exploitation of its monopoly position in a market where there is inadequate competition, or reflect its success in conditions of effective competition.

The profitability of Nestlé

7.53. As stated in paragraph 7.22, Nestlé's return on tangible capital employed in 1989 was some 114 per cent, considerably above the average rate of profitability elsewhere in the economy, or in the food, drink and tobacco sector industry in particular (details of which are shown in Table 4.38). Nestlé put forward a number of arguments to show why, in its view, the conventional way of measuring return on capital employed may overstate its profitability.

7.54. Nestlé pointed to the abnormal age distribution and conservative depreciation of its fixed assets, many of which have been fully depreciated. Its figure for capital employed-£88 million in 1989-had therefore declined compared with 1985, although output had increased, and this, coupled with the fact that Nestlé was about to embark on a £70 million programme of capital expenditure, indicated that it was artificially low. On what Nestlé regarded as a more realistic measure, its capital employed would be £122 million, and its rate of return would be reduced to some 80 per cent. Nestlé also pointed to the (more minor) impact on its asset base of the low value attributed to coffee stocks, reflecting the fact that coffee prices are in its view at present below the long-term average.

7.55. It is the MMC's normal practice to measure capital employed in accordance with the principles adopted in preparing a company's accounts. We accept that, to some extent, Nestlé's apparent high profitability reflects the fact that some of its fixed assets have a zero book value. Such factors tend to cancel out over time, however, and although Nestlé's profits may be somewhat overstated now, they were probably correspondingly understated in earlier years. Even allowing for both the age profile of Nestlé's assets, and the possibly abnormally low value of its coffee stocks, its return on capital employed would still be in the order of 70 per cent, a high rate of return by any criteria.

7.56. A further argument raised by Nestlé was that the accounting measure of capital employed excluded the value of its brands. Goodwill, including brand values, arising on acquisition is sometimes included in published balance sheets, but it is not the general practice to attribute a value to brands where it has been internally generated, although a number of well-known companies have started to do so in recent years. Nestlé provided us with a valuation of its brands by Interbrands UK Ltd, made for the purpose of our inquiry, of some £253 million. This valuation, it emphasised, was not intended to arrive at an arm's length value of what the brands might fetch if sold, as it was intended to exclude any element that might represent the capitalisation of monopoly profits.

7.57. We must clearly accept that successful brands do have value to their owner and indeed are helpful to consumers, who may prefer to choose branded products for their assurance of reliable quality. There are doubts, however, as to whether brands can be valued with any accuracy in the absence of the evidence provided by an arm's length sale. It is also difficult to distinguish to what extent profits result from the development of a successful brand in a competitive market, and to what extent they result from monopoly profits in a market that is not fully competitive. Although Nestlé believed that the brand valuation it provided to us avoided any circularity of approach-by which the value of 'monopoly' profits would be capitalised, thus reducing the return on capital to a normal level-any approach to the measurement of profitability by reference to a capital base that includes brand values or goodwill must, in our view, introduce an element of circularity, in so far as it places a value on the ability of the business to earn profits in excess of the normal return on its tangible capital. Moreover the criteria that were used in evaluating the strength of the brands themselves depended on the extent to which the products were 'market leaders'. An alternative approach used by Nestlé, which involved capitalising and then amortising advertising expenditure, is also subjective in that it depends heavily on the rate of amortisation used.

7.58. A further difficulty in including brand values is that to do so would invalidate comparisons with the profitability of industry generally, or with other firms in the food, drink and tobacco manufacturing sector, the profitability statistics for which do not take account of the value of brands. To the extent, therefore, that other firms in the sector have successful brands, figures for the average profitability of the sector, with which it would seem appropriate to compare Nestlé's profits, would be correspondingly overstated. We have not, therefore, felt it appropriate, in considering Nestlé's profitability for the purpose of this inquiry, to take account of the value of Nestlé brands, but have considered its profitability on the basis of its tangible capital employed.

7.59. Nestlé also argued that the profitability of its reference business could not be considered in isolation from the rest of its business. As shown in Table 4.8, its overall return on capital employed in 1989 was over 40 per cent, considerably higher than for industry generally, but well below that of its reference business. Nestlé suggested that any food manufacturer would have a mix of more and less successful activities. Although it did not believe that there was any intentional cross-subsidisation, it argued that high returns were necessary on the more successful activities, if a company was to risk investing across the range of its activities, and was to develop new products. It further argued that the profitability it achieved on its most successful brands should be compared with the profitability achieved by other food companies on their successful brands and indeed Nestlé gave us examples of some of its other successful brands in competitive markets with returns on capital employed similar to that on soluble coffee. In this connection, Nestlé emphasised that Nescafé is one of a relatively small number of uniquely successful products in the food market, and that its profitability reflects that. In turn, Nescafé's profitability is a major contributor to the profitability of Nestlé's coffee business (see paragraph 7.22).

7.60. We, however, have to examine only the soluble coffee market and have available to us only aggregate information on other companies. In these circumstances, therefore, we seem to have little alternative but to consider Nestlé's profits on its reference business alone compared with those in the economy in general, or the food manufacturing industry in particular.

7.61. Nestlé also argued that we should not have regard only to the more recent levels of profitability on its reference business. Average returns on capital on soluble coffee over the period 1976 to 1989 were around 50 per cent, regardless of whether historical or replacement costs are used; Nestlé believed that profitability was currently at a peak (although maintained in 1990) and that such high profits were unlikely to recur. It would, however, seem wrong to us to discount the very high profitability-of about 100 per cent or more over the last three years-by reference to its lower profitability of the earlier ten years.

7.62. In our view, therefore, we have to consider the recent profitability of Nestlé's reference business as measured in accordance with principles adopted in preparing its accounts, while acknowledging that this may be overstated to an extent by the present age profile of its assets and possibly the current low coffee bean prices. On this basis Nestlé's profitability is high, relative both to other industries and to other enterprises in its own industry. High profits can, however, be viewed as the reward for success in a competitive industry: we have to consider whether this is so in Nestlé's case, or whether its high profitability reflects its monopoly position in the market, possibly in conjunction with the ineffectiveness of competition, or potential competition, in that market.

Anti-competitive practices

7.63. We have seen no evidence of 'anti-competitive' practices by Nestlé, and indeed Nestlé's competitors tended to speak highly of Nestlé's efficiency and reputation for fair business practices and to be more concerned about the possible adverse consequences for them of any regulatory action following our report than about any actions by Nestlé. We are, for example, aware of no attempt by Nestlé to restrict the sale of its competitors' coffees in an uncompetitive manner, nor has Nestlé attempted to drive its competitors from the market by short-term price competition. We have indeed received very few complaints about any aspect of Nestlé's conduct or performance. We have seen details of legal actions brought by Nestlé to prevent unauthorised imports of lower quality Nestlé branded coffee from Colombia (where it was subsidised for domestic consumption) and Brazil. Nestlé's action in these circumstances would not seem unreasonable.

The effectiveness of competition

7.64. As discussed in paragraph 7.12, there are well in excess of 200 types of soluble coffee available in the United Kingdom produced by a dozen or more suppliers. In June 1990, retail prices for 100 gramme packs of the more important types of soluble coffee in major multiple stores ranged from about 50p for coffee/chicory mixtures to £2.55 for Cap Colombie and Alta Rica. Nescafé itself was sold at a premium of some 5p per 100 grammes on the Maxwell House price, and at a significantly larger premium on own-label granulated coffee prices. Consumer preference for the leading Nestlé brands, particularly for Nescafé, the main contributor to its profitability, reflects therefore the outcome of consumer choice among a wide range of alternatives and a preference for a perceived higher quality at a somewhat higher price.

7.65. Although there is a wide range of choice available, and a number of competing suppliers, we still, however, have to consider whether Nestlé's market position is such as to limit the effectiveness of this competition, or enable Nestlé, for example, to set the overall level of prices in the industry.

7.66. As discussed in paragraph 7.31, competition between soluble coffees has been described as 'value for money', encompassing quality improvements, price and brand image, supported by advertising. The market research studies we have seen confirm that quality has improved over time, and that most participants in the market are continuing to improve the quality of their products. Given the continuing choice available to consumers, with a wide spectrum of price and quality alternatives, these improvements in quality would appear to accord with consumer preferences. Nestlé has indeed increased its market share at the expense of own label by offering higher quality and better value for money, despite higher prices. The increasing success of its brands, particularly of Nescafé, given the extent of choice available reflects

Nestlé's success as a competitor in offering a reliable product at a quality and price in accordance with consumer preference.

7.67. We have considered to what extent the emphasis on quality has reduced price competition. We have noted the similar movements in the list prices of Nescafé and Maxwell House. There is, however, a greater variation in manufacturers' prices, taking account of discounts, and more intensive price competition in supplying own-label coffees. Own-label price movements have not therefore always followed the lead of the main brands, and competition from own label would seem to provide at least some further constraint on the pricing policies of both Nestlé and GFL, particularly as retailers establish a higher quality image for their own-label soluble coffees. Despite the wide range of retail prices, there has, however, been little aggressive price competition to Nestlé from soluble coffees of comparable quality.

7.68. Competition may strengthen further. GFL has acknowledged that its performance in the past has not been as effective as it could have been, but is clearly determined to continue to improve the quality of its products. The quality of several own-label soluble coffees is also being improved so that they will offer a quality more comparable with that of Nestlé or GFL but at lower prices.

The position of Nestlé's competitors

7.69. We have also considered the extent to which the other suppliers in the market are in a position to compete effectively with Nestlé. Their soluble coffee businesses are clearly much less profitable than that of Nestlé, but the main competitors are part of larger groups in a position to support their activities in this market, and there are a number of other major food companies (such as Douwe Egberts) whose presence in the market is at present only limited. It is indeed possible that present price levels have encouraged some of these competitors to stay in the market, thus improving the outlook for competition in the longer term.

7.70. Nestlé's success would, however, appear to have given it a number of competitive advantages. Its lower unit costs, both of production and of advertising, may in part reflect the scale economies given by a market share at least twice the size of its biggest competitor. It clearly has a strong brand image, well supported by advertising, which may benefit from the umbrella 'Nescafé' branding it employs, but is also sustained by the reliability of its product.

7.71. Nestlé is not, however, in an unchallengeable position: it pointed to GFL's experience in the United States, where the market share of Maxwell House declined from 40 per cent to 20 per cent over a 25-year period. A similar major change could in our view occur in the United Kingdom market, should the quality of Nestlé's product or its competitive performance deteriorate, its prices increase beyond a competitive level, or its competitors equal or surpass its present quality or performance.

The position of retailers

7.72. We also believe that retailers' own-label coffees are in a strong competitive position, despite their decline in market share in the last ten years. Retailers are able to determine the allocation of shelf space, and thus the positioning of their and their competitors' products: retailers have also attempted, in so far as they are able, to adopt some of the features of the Nestlé brands. Any improvement in the quality of retailers' own-label coffees would, in our view, improve their competitive position further.

7.73. Nestlé would appear to derive some advantage from the lower retail margins on its products as a result of which the differences in manufacturers' prices between Nestlé and its competitors are not fully reflected in price differences at retail level. This advantage arises in turn from Nestlé's market position and competition between retailers themselves: Nestlé cannot be regarded as imposing such lower margins, or determining retail prices.

7.74. The lower retail margins on Nestlé's products may in part reflect their higher stockturn, a further advantageous consequence of its strong position in the market. Retailers would, however, also seem unable to exert any significant countervailing power over Nestlé. Given the strength of its brands in the market-place they are not in a position to refuse to stock Nescafé. Given that Nescafé is one of a number of 'known value items' on which competition between retailers is most intensive, retailers also have little option but to accept lower margins on the Nestlé brands.

7.75. Retailers are, by contrast, able to obtain lower manufacturers' prices and thus earn higher margins, on lesser brands and on own-label soluble coffees, which indeed provides them with an inducement to stock such products. The other manufacturers to whom we spoke agreed that the higher retail margins on their products put them at some disadvantage compared with Nestlé: but did not believe that this disadvantage was sufficient to prevent them from offering effective competition to Nestlé.

Entry

7.76. Nestlé's success in establishing its position in the market and its strong brand image also give it some advantage over new entrants to the market. New entrants have to offer retailers higher margins if their products are to be stocked, and retailers may require new brands to perform well in a short time if they are to continue to be stocked, and adequate advertising of such brands to ensure their good performance.

7.77. Such advertising costs would not, however, seem particularly high for branded grocery products. There is also no shortage in the supply of soluble coffee for import into the United Kingdom. The disadvantages would not therefore seem to be so great as to deter entry to the market, and a number of new entrants have built up niche market positions. There may be less prospect of new entrants competing with Nestlé head-on although we have not come across any case where Nestlé has aggressively retaliated against competition. Any deterioration in Nestlé's performance would, however, in our view be expected to lead to more sustained competition from new entrants into the industry.

Whether Nestlé's profitability reflects ineffective competition

7.78. While we can point to a number of advantages to Nestlé that arise from its market position, and various weaknesses in the position of its competitors, we do not believe that competition can be characterised as 'ineffective'. Competition has brought the benefits of considerable consumer choice, and of improvements in quality and, in our view, while there may have been little aggressive price competition, there is sufficient competition or potential competition on prices to set a ceiling to the prices that can be charged by Nestlé. Nestlé's very advantages stem from its success as a competitor; it has increased its market share by offering a good quality product, its advertising is more effective, its leading brands stronger, and in a number of other ways it appears to have been more efficient than its competitors. Its position reflects its success: it cannot disregard its competitors who are either members of major food groups, or retailers with own-label coffee, the latter being well placed to promote their products at the expense of Nestlé's.

7.79. It may be regretted that no other firm has to date proved as effective a competitor as Nestlé, but this is no reason, we feel, to conclude that Nestlé's performance is against the public interest, or to intervene in the market. Nestlé is, in our view, a highly effective and successful competitor in this market: its high profitability need not lead us to penalise that success in a market characterised by such a wide degree of choice. Its high profitability should indeed be seen as an incentive for other firms to compete in this lucrative market.

7.80. Regulatory intervention, in the event of an adverse finding, could offer some short-term benefits in the form of price reductions, but-particularly given the poorer profitability of Nestlé's competitors-it would carry the considerable risk of there being less choice, poorer quality and weaker competition in the long run. The interests of consumers, who already have the option of purchasing cheaper coffee should they so choose, are in our view best served by the maintenance of competition. Only if there were to be a significant deterioration in the competitive structure of the market-such as, for example, the withdrawal of all or some of Nestlé's competitors or the abandonment by retailers of their own-label coffees-do we

believe that intervention should be considered. In the present market situation intervention would itself be likely to cause such a deterioration in market structure, and cause the withdrawal of some suppliers from the market with adverse consequences in the longer term.

The adjustment of soluble coffee prices to coffee bean prices

7.81. The slow adjustment of soluble coffee prices to movements in world prices of green coffee beans, particularly following the sharp fall in green bean prices in the summer of 1989 and the longer-term relationship between soluble coffee prices and the cost of coffee beans, was one of the main concerns prompting this inquiry. As mentioned in paragraph 7.41, the cost of coffee beans accounted in 1985 for less than one-half of the price of soluble coffee received by Nestlé, and by 1989 for little more than one-quarter. Both manufacturers' and retail prices for soluble coffee cannot therefore be expected to fluctuate to the same extent as coffee bean prices, and will reflect other elements of cost.

7.82. The manufacturers' prices of own-label coffees did, however, respond much more quickly to the recent fall in commodity prices than did those of branded coffees. While we accept Nestlé's explanation that it was not until mid-December 1989 that the fall in commodity prices was reflected in its costs, we believe that price adjustments could have been made before, rather than after, the Christmas period. We have, however, also noted the evidence of GFL that over the longer term there was no systematic asymmetry in the adjustment of its prices in real terms to coffee costs, and that changes in its costs tended in time to be fully reflected by changes in its wholesale prices.

7.83. There is, however, a considerable element of discretion in how manufacturers respond to changes in their costs. Nestlé, for example, anticipated cost increases in early 1986, in order to 'average', and hence limit, its own price increases; similarly Nestlé was free to decide to wait to reduce prices in January 1990, rather than do so in December 1989, or have to respond to price changes in the market.

7.84. At least until 1989, furthermore, reduction in green bean costs coincided with an increase in manufacturers' (and, to a lesser extent, retailers') margins between their selling prices and the cost of coffee beans, the fall in green bean costs not having been fully passed on in retail prices. In the case of Nestlé, absorption of at least part of the fall in green bean costs contributed to the increase in its profitability until 1989; although in the case of GFL, this fall was offset by other cost increases.

7.85. We do not, however, believe that we can consider the relationship between manufacturers' prices and coffee bean costs in isolation from the general structure of the market. Nestlé was in our view able to maintain prices, in a competitive market, only by offering good quality products at prices consumers were prepared to pay; at all times, over this period, consumers had an ample choice of alternative products, and the option of paying significantly lower prices albeit for somewhat lower quality, if they so chose. The price of some own-label soluble coffees did indeed recently fall more rapidly in line with commodity prices: consumer preference for Nestlé, however, enabled it to maintain its prices.

7.86. We also note that it was only in the case of Nestlé that the longer-term increase in the margin between coffee bean costs and manufacturers' prices led to high profits: the profitability of the other firms in the industry cannot be regarded as particularly high and has not generally shown any upward trend in recent years: in some cases it has in fact declined. Given the degree of choice and competition in the market, we would not therefore regard the slow adjustment where it occurred of soluble coffee manufacturers' and retail prices to green bean costs as sufficient justification for intervention. In 1990, indeed, Nestlé's prices are expected to fall by more than its coffee costs, reducing its profitability per tonne of coffee sold.

Conclusions

7.87. We have established that Nestlé's profitability in the supply of soluble coffee for retail sale is considerably higher than that of industry in general, or of the food, drink and tobacco sector in particular. In our view, however, this profitability has arisen in a market with a wide degree of consumer choice and effective competition. Although, in some respects, there has apparently been little aggressive price competition, competition is sufficiently effective to bring consumers the benefit of wide choice of prices and quality, and improvement in quality and in perceived value for money. We have not identified sufficient weaknesses in price competition to justify a finding that any aspect of the industry operates against the public interest, or intervention in the market which we believe would be to the detriment of consumers in the longer term.

7.88. On the remaining questions in our terms of reference (see paragraph 7.4), we are asked to consider whether any steps (by way of uncompetitive practices or otherwise) are being taken by Nestlé for the purpose of maintaining or exploiting its monopoly situation, and if so by what uncompetitive practices, or in what other way. It would not, in our view, be appropriate to interpret this question to include what could reasonably be regarded as the ordinary business practices of a company undertaken to maintain or expand its market share, given the extent of competition in the market concerned. We have found no evidence of uncompetitive practices by Nestlé nor, in the circumstances of this market, do we believe that Nestlé is taking any other steps with the deliberate intention of maintaining or exploiting its monopoly situation. Similarly, in the circumstances of this market, we have found no action or omission on the part of Nestlé attributable to the existence of the monopoly situation.

7.89. Finally, we are asked whether any facts found in pursuance of our investigation operate or may be expected to operate against the public interest. Nestlé has a strong market position—a market share of almost 50 per cent by volume, over 50 per cent by value—and its profits are clearly high. In our view, however, Nestlé has achieved such a market share, and such a degree of profitability, by operating efficiently and by successfully developing products and brands that consumers regard as offering good value for money, in a market characterised by a wide degree of choice for the consumer, and by competition both from other brands of soluble coffee, and from retailers' own-label coffee. Its profitability, in our view, reflects its success in meeting consumers' preferences in an effectively competitive market. In these circumstances, we have found no facts which operate or may be expected to operate against the public interest.

H H HUNT (*Chairman*)

J D KEIR

R O DAVIES

G C S MATHER

C A UNWIN

S N BURBRIDGE (*Secretary*)

8 January 1991