

Supermarkets

A report on the supply of groceries from
multiple stores in the United Kingdom

Volume 2: Background chapters



COMPETITION COMMISSION

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from multiple stores in the United
Kingdom

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**Presented to Parliament by the Secretary of State
for Trade and Industry by Command of Her Majesty
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Contents

	<i>Page</i>
Part II—Background and evidence	
<i>Chapter</i> 3 Background to the inquiry.....	3
4 Market definition.....	11
5 The main parties.....	39
6 The market.....	75
7 Pricing.....	105
8 Profitability.....	145
9 International price comparisons.....	181
10 Operating costs and quality of service.....	209
11 The relationship between the main parties and their suppliers.....	229
12 Land and planning issues.....	260
13 Social and environmental issues.....	295
14 Views of main parties.....	325
15 Views of other interested parties.....	421
List of signatories.....	505

Note by the Department of Trade and Industry

In accordance with section 83(3) and (3A) of the Fair Trading Act 1973, the Secretary of State has excluded from the copies of the report, as laid before Parliament and as published, certain matters, publication of which appears to the Secretary of State to be against the public interest, or which he considers would not be in the public interest to disclose and which, in his opinion, would seriously and prejudicially affect certain interests.

The omissions are indicated by a note in the text or, where space does not permit, by the symbol ✂.

Part II

Background and evidence

3 Background to the inquiry

Contents

	<i>Page</i>
Introduction	3
Background: grocery retailing	3
Background to the inquiry	4
The principal concerns of the Director General of Fair Trading	5
The OFT study	6
Conduct of the inquiry	7
The report	8

Introduction

3.1. The DGFT, in exercise of his powers under the FTA, referred the supply of groceries from multiple stores to the CC for investigation on 8 April 1999. The terms of reference related to the possible existence of a monopoly situation in relation to the supply in Great Britain of groceries from stores:

- (a) where the space devoted to the retail sale of groceries exceeded 600 sq metres;
- (b) where the space devoted to the retail sale of food and non-alcoholic drinks exceeded 300 sq metres; and
- (c) which were controlled by a person who controlled ten or more such stores.

The terms of reference were subsequently amended to refer to the UK, rather than Great Britain.

3.2. The terms of reference defined ‘groceries’ as including food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods, but as excluding petrol, clothing, DIY products and financial services. ‘Food’ was defined as excluding food sold for consumption in the store. The CC considered that pharmaceuticals were not groceries and were not included, and that the term ‘household goods’ should also exclude newspapers, magazines and greeting cards, compact discs, video and audio tapes, toys, plants and flowers and all electrical appliances.

3.3. The DGFT asked that the CC report on the reference within a period of one year, by 7 April 2000. Subsequently the inquiry was extended until 31 July 2000. The terms of reference from the DGFT are in Appendix 1.1, and the Press Release by the OFT announcing the reference is at Appendix 3.1.

Background:¹ grocery retailing

3.4. The overall market for groceries (including non-food) is one of the most significant in the UK, amounting to over £90 billion in 1998. Food is the single largest component of consumer expenditure on durable and non-durable goods, and the large supermarkets are among the most significant retailers with familiar fascias in any high street or shopping centre.

¹This section of the chapter draws on material from *The Grocers* by Andrew Seth and Geoffrey Randall, published by Kogan Page, 1999.

3.5. The grocery market has increased by 53 per cent since 1990 in terms of growth in sales, or 23 per cent at constant 1995 prices. This reflects in part higher prices, and in part higher value-added consumption. The number of supermarkets has grown from a little over 4,000 in 1992 to almost 4,500 today. The growth in the numbers of stores has, until recently, been matched by their growth in size. The average supermarket store size in 1997/98 was around 2,325 sq metres (approximately 25,000 sq feet), compared with under 1,860 sq metres (approximately 20,000 sq feet) five years earlier. However, some stores are substantially greater, for example Asda's average store size is over 3,700 sq metres (about 40,000 sq feet).

3.6. Supermarkets are the product of 150 years' development. Companies operating multiple stores emerged in the 1850s, and by the 1890s food retailers had become the largest such group; 30 years later they formed over half the UK total with over 13,000 multiple food shops. The early shops were basic, but more advanced retailing techniques were beginning to be adopted through brightly-lit displays designed to attract passers-by. Price ticketing also became common, and competition led to the speedy development of advertising and selling methods.¹

3.7. At the same time manufacturers started to develop national brands, advertise them directly to consumers and deliver to retailers. *The Times* of August 1902 noted the 'Passing of the grocer', ground between the upper and lower millstones of the growing Co-operative movement and the company shops such as Home and Colonial Stores. Many of the features of modern grocery retailing were already in place by the early years of the twentieth century.

3.8. The emergence of the bigger chain stores soon followed, first in the USA and then in Great Britain where between 1924 and 1931 several grocery firms merged with Home and Colonial Stores to form a company with over 3,000 branches. International Tea grew to over 1,000 branches. The Second World War led to rationing and price controls that put a temporary stop to further development and had a central influence on what happened afterwards. The war and the raising of the school-leaving age reduced the supply of cheap labour and led to the adoption (starting in 1947) of a form of selling first experienced as early as 1916 in the USA—self-service.

3.9. Multiple grocers embraced self-service, and they also discovered that the increasing size of stores brought economies of scale. Supermarkets started to spread, from a few hundred stores in the late 1950s, to around 2,000 by 1965, to almost 4,500 today. Around 40 per cent of these stores are now accounted for by the four 'majors': Asda, Safeway, Sainsbury and Tesco.

3.10. More recently the rate of growth has slowed and multiples have had to look to new ways of generating profit other than through increasing volume. The market for groceries is mature and the proportion of national wealth spent on food has declined—from 16.7 per cent of household expenditure in 1971 to 10.9 per cent in 1997. Space for growth is another limiting factor, as grocery multiples have to find commercially viable sites, but also satisfy stringent planning regulations (see also Chapter 12).

3.11. There have now, however, been new developments in food ranges, with a growth in sales of, for example, fresh food, ready meals and organic foods. Channels of distribution are also changing with the introduction of home delivery and electronic home shopping, while the multiples have developed their range of customer services to include in-store or on-site facilities such as fish counters, pharmacies, banking and petrol stations.

3.12. The market for groceries is discussed in greater detail in Chapters 4 and 6. Information on the market participants can be found in Chapter 5.

Background to the inquiry

3.13. In the late 1990s there was growing comment on the grocery multiples and their prices and profits, much of it critical. This came from political quarters, from sections of the food production, processing and retailing industries and from other bodies such as those representing consumers. Among comments made, some of them direct to the OFT, were those from:

¹John Ruskin, the nineteenth century man of letters and art critic, ascribed the failure of his tea shop in the 1870s to these new techniques: 'The result of this experiment has been my ascertaining that the poor only like to buy their tea where it is brilliantly lit and eloquently ticketed. I resolutely refuse to compete with my neighbouring tradesmen either in gas or rhetoric!'

- (a) The House of Commons Welsh Affairs Committee: in 1998 the Committee published a report *The Present Crisis in the Welsh Livestock Industry*¹ which called for the OFT to investigate vertical restraints in the meat market and the disparity in prices between farm gate and supermarket. The Welsh Office Agriculture Department endorsed the report, and the Government, in its response to the Committee, expressed understanding of its concerns.
- (b) The Liberal Democratic Party produced a report in May 1998, *Checking out the Supermarkets*. A particular concern was the alleged threat posed to smaller town centre shops by larger out-of-town supermarkets. At the same time the report said that competition legislation should be capable of dealing with the existence of local and regional supermarket monopolies.
- (c) The British Brands Group sent the OFT a copy of Dr Paul Dobson's study for Nottingham University on *The Competition Effects of Look-Alike Products* which it felt raised some interesting issues. The report suggested that 'the market power and control over the supply chain which the major retailers now enjoy means that by developing look-alike products they are best placed to exploit unfairly and anti-competitively the image and goodwill that brand manufacturers have developed'. This, it felt, distorted manufacturer and retailer competition to the detriment of consumer welfare and the public interest.
- (d) Representations were also received by the OFT from the Consumers' Association on the effects of retailers' own-label products and a policy paper on Look-alikes. The paper suggested that there might be a code of practice between multiples and manufacturers on issues such as packaging and shelf location. Nevertheless, it concluded that manufacturers themselves should solve the problem by labelling their brands clearly.
- (e) The OFT received correspondence in connection with various agricultural certification schemes (FABPIGS, Assured Produce Scheme etc) alleging that these were being used by retailers to restrict production.
- (f) In July 1998 Tesco produced a report which it had commissioned from LE on the supply chain for beef and lamb in the UK. This acknowledged that the fall in farm-gate prices following the BSE crisis was sharper than the fall in retail prices. However, the paper claimed that this increased 'price spread' was accounted for by the increased costs on abattoirs, processors and retailers, and the costs of rebuilding the consumer market in beef. Figures from the MLC showed that in late 1997 the margins at processing and retail levels still accounted for only 10p of the final price of over £3 a kilo. At this price Tesco had found that its costs were not covered.
- (g) An OFT Research Paper published in September 1998, *The Welfare Consequences of the Exercise of Buyer Power* by Dobson, Waterson and Chu (OFT Research Paper 16), argued that the continued consolidation in the food retail sector was a cause for concern. This was in relation not only to increased selling power, but also potential abuse of buyer power. Retail consolidation gave the major chain stores a tight 'gate-keeper' role in relation to shelf access which meant that they were increasingly able to exercise buyer power. Recent trends in UK retailing showed a growth in concentration, with average gross and net margins which suggested that retailers were able to retain the benefits from their increased bargaining power rather than passing them to consumers.

3.14. More recently there has been media comment that grocery prices were higher in the UK than in the rest of the EC or the USA. This culminated in a campaign in the press and other media. Responding to these concerns (which were in respect of a broad range of goods, not just groceries), the Department of Trade and Industry conducted an investigation which found that for a small number of the goods studied Great Britain was more expensive, for an even smaller number it was cheaper, but for the majority of goods prices were similar.

The principal concerns of the Director General of Fair Trading

3.15. The OFT told us that it had always monitored food retailing carefully, given its importance to the economic welfare of consumers. There had been long-standing general concern about the

¹*The Present Crisis in the Welsh Livestock Industry*; Welsh Affairs Committee Second Report of Session 1997-98, HC 751, 20 May 1998.

implications of the growth of the major companies in the industry, the impact of their out-of-town superstores on traditional town centre shopping areas, and about a reduction in competition.

3.16. The starting point of the OFT's work had been a report by the MMC in 1981, *Discounts to Retailers*,¹ which had concluded that consumers were not suffering from the actions of the grocery multiples. It had also found that the multiples used their buying power to obtain discounts from suppliers that were passed on in lower prices. This was a conclusion supported by the OFT's own research and that of outside bodies. An investigation carried out by the OFT in 1996, prompted by a complaint from the Association of Master Bakers, had not led to different conclusions. However, as paragraphs 3.13 and 3.14 illustrate, by 1997/98 concerns were rising and there was adverse criticism in the press, from the public and in particular from the agricultural sector.

The OFT study

3.17. The OFT therefore decided in June 1998 to undertake a study of grocery multiples. It confined its examination to Asda, Safeway, Sainsbury and Tesco, and looked especially at the retail margins and profitability of their core grocery retailing where they might have market power.

3.18. It was decided that there should be two stages in the work. The first was designed to establish whether the grocery retailers were earning excess profits; and then (if necessary) a second stage to investigate where the profits were coming from, how they were being earned and the effect of competition on them.

3.19. The OFT study was informed by a questionnaire sent to the major multiples in September 1998. The analysis of their replies in early 1999 suggested to the OFT that:

- (a) the four multiples had over 60 per cent of the one-stop shop groceries market;
- (b) there were significant barriers to entry due to (i) few good sites remaining that could be developed for grocery retailing and (ii) the lack of available product niches;
- (c) price competition between the Big 4 was oligopolistic, with muted price competition and a tendency to follow prices rather than cut them;
- (d) there were too many product lines to assess whether any particular one was priced excessively; and
- (e) there was not much scope for new entrants, nor was it likely that there would be more intense competition between existing multiples because of a dearth of new sites and no obvious niche markets that were unfilled that would allow entry by means of less traditional locations and product offers.

3.20. In March 1999, the OFT produced its assessment of the profitability of grocery multiples. It had examined profitability using accounting-based measures such as return on capital employed (ROCE), return on sales (ROS), the accounting rate of return (ARR) and the certainty equivalent accounting rate of return (CARR—a methodology first set out in its own Research Paper No 10). The main findings were:

- (a) Some multiples showed evidence of excess profits, others did not, and those that did might be enjoying local monopolies sustained by planning restrictions. Possible remedies might be better accounting disclosure and divestment of some stores.
- (b) On property valuation, ordinarily, there was no premium for food-retailing land. Some companies were, however, prepared to pay large premiums to prevent or deter other retailers from opening competing stores.

¹*Discounts to Retailers: a report on the general effect on the public interest of the practice of charging some retailers lower prices than others or providing special benefits to some retailers where the difference cannot be attributed to savings in the supplier's costs*, HMSO, HC 311, May 1981.

- (c) Differences in unit costs might relate to efficiency; but there was also evidence that some stores might be incurring high costs to drive up sales rather than compete on price.
- (d) Share price data pointed to poor returns in the sector overall, but it neither supported nor refuted charges of excess profitability.
- (e) Although many pricing and marketing decisions were made nationally, the intensity of price competition seemed to depend on the number of stores in any particular catchment area.

3.21. As a result of the OFT inquiry, the DGFT's principal concerns could be summarized as being:

- (a) the nature, extent and existence of barriers to entering the market on a competitive scale;
- (b) the extent to which land was increasingly impacting on the cost structure of competing firms;
- (c) the intensity of price competition at local, regional and national levels; and
- (d) the nature of the relationship between the multiples and their suppliers, including agricultural producers and the ways in which buyer power was exercised.

3.22. In the light of these first-stage conclusions and the concerns they pointed to, it was felt that the proposed second stage of examining the multiples' profits, and the effect of competition on them, would be better discharged by a more general investigation by the CC. As a result, the reference was made on 8 April 1999.

Conduct of the inquiry

3.23. After the reference was made, the CC wrote to 101 companies operating multiple grocery stores asking for information on the numbers and size of their stores to determine whether they came within the terms of reference. We found that 24 companies operated ten or more reference stores. These companies are referred to as the main parties to our inquiry. Their full names and the short titles we have used in this report are set out in Table 3.1. We decided that the inquiry should concentrate on a smaller number of the main parties in its detailed investigations, in particular on those likely to have the most significant impact on the market. The detailed criteria used for this selection are discussed and set out in paragraphs 2.328, 2.330 and 2.458, and paragraphs 5.22 to 5.24.

TABLE 3.1 **The main parties**

<i>Name</i>	<i>Short name</i>
Aldi Stores Ltd	Aldi
Anglia Regional Co-operative Society Ltd	Anglia Co-op
ASDA Group Ltd	Asda
Budgens Stores Ltd	Budgens
Colchester and East Essex Co-operative Society Ltd	Colchester Co-op
CRS Ltd	CRS
CWS Ltd	CWS
E H Booth & Co Ltd	Booth
Iceland Frozen Foods plc	Iceland
Lidl UK GmbH	Lidl
Marks & Spencer plc	M&S
Midlands Co-operative Society Ltd	Midlands Co-op
Netto Foodstores Ltd	Netto
Oxford, Swindon and Gloucester Co-operative Society Ltd	Oxford Co-op
Plymouth and South Devon Co-operative Society Ltd	Plymouth Co-op
Safeway plc	Safeway
Sainsbury's Supermarkets Ltd and Savacentre Ltd	Sainsbury
Scottish Midland Co-operative Society Ltd	Scotmid
Somerfield plc	Somerfield
Tesco plc	Tesco
United Norwest Co-operatives	United Norwest
Waitrose Ltd	Waitrose
Wm Morrison Supermarkets plc	Morrison
Yorkshire Co-operatives Ltd	Yorkshire Co-op

Source: CC.

3.24. During the 16 months of the inquiry, we received over 400 submissions from main and third parties, of which over 90 were from the main parties. We held over 50 hearings with interested parties—mainly in London, but also in Belfast to examine the particular features of the grocery market in Northern Ireland, and an open hearing in Birmingham specifically on planning issues. Members of the Group conducting the inquiry also visited the stores of some of the main parties, which allowed them the opportunity to talk to management, staff and customers. A total of 12 hearings were held with Asda, Morrison, Safeway, Sainsbury and Tesco to discuss the issues arising from the reference (as given in the Issues Letter of 31 January 2000—see Appendix 2.1), and then again to discuss possible remedies (as given in the Remedies Letter of 21 February 2000—see Appendix 2.3).

3.25. We also obtained data from questionnaires sent to consumers, all the main grocery retailers, nearly 400 suppliers of groceries to the main parties and 66 local authorities. In total, questionnaire responses were received from more than 1,500 respondents. We analysed a range of key factors relevant to a proper understanding of grocery retailing, including: price trends for individual companies and for groceries in general; profitability and the cost of capital; costs and efficiency; profitability of different product groups; international comparisons of profitability; local, regional and national market concentration; price competition in local markets; patterns of price leadership; persistent selling at a loss; branded and retailers' own-label comparisons; international price comparisons; land prices, the acquisition of land for supermarkets and the impact of the planning system in the UK; relationships with suppliers and suppliers' margins; transmission of price changes from suppliers through to consumers; and consumer surveys.

The report

3.26. The central chapters of this report examine these key aspects of supermarket grocery retailing, in relation to competition issues and the supply of groceries from stores that are large enough to supply a range of goods that shoppers might need if they shopped only once a week.

3.27. Specifically:

- (a) *Chapter 4—Market definition* defines the market for groceries, the geographic market and the catchment areas of supermarkets, examines consumer preferences, issues of market segmentation and shopper loyalty or switching behaviour.
- (b) *Chapter 5—The main parties* describes the 24 companies which operate stores within the terms of reference, their market shares and store portfolios and business strategies.
- (c) *Chapter 6—The market* examines recent trends in grocery retailing, the structure of local markets, the availability of a choice of stores for consumers, the nature of competition and innovation in the market, brand presence and marketing, recent developments affecting the operation of the market and barriers to entry.
- (d) *Chapter 7—Pricing* examines trends in prices and relative prices, pricing policies and pricing tactics including: promotions, price matching, below-cost selling, price leadership, own-label pricing and the pass-through to retail prices of cost changes. The chapter concludes with an assessment of price competition overall.
- (e) *Chapter 8—Profitability*: this examines the profitability of the main parties in terms of gross and operating profit margins, describes the IRR achieved by the larger multiples and their ROCE compared with average cost of capital, and looks at product group profitability and the profitability of selected own-label and comparable branded products. The chapter also considers the profitability of 'monopoly' stores facing limited local competition, and stores subject to differential pricing arrangements (price flexing).
- (f) *Chapter 9—International price comparisons*: this covers the methodology and findings of international price comparisons by the CC and others.
- (g) *Chapter 10—Operating costs and quality of service* looks at operating costs, factors affecting costs, monitoring costs and efficiency, quality, range and service issues, and international cost comparisons.

- (h) *Chapter 11—The relationship between the main parties and their suppliers:* this includes a description of suppliers to the main parties, contractual and other arrangements between them, practices of the main parties that are of concern to suppliers, supplier profitability, product quality and innovation, supply chain issues, and international comparisons.
- (i) *Chapter 12—Land and planning issues* looks at the land use planning regime and its operation in practice, whether there are any implications for the cost structure of the supermarket operators or resulting barriers to entry, capital investment appraisals, land and development costs, alternative use values and relevant international comparisons.
- (j) *Chapter 13—Social and environmental issues* examines four key issues of potential concern: the net effects on employment resulting from the greater prominence of the large superstores; the decline in town centres and district centres and the interdependent trading arrangements between local suppliers and retailers that exist within them, the closure of smaller shops and the potential decline of public transport in rural areas; potential problems concerning access to groceries for low-income customers and groups with restricted mobility; and finally environmental concerns predominantly stemming from the siting of new stores.
- (k) *Chapter 14—Views of main parties* summarizes submissions and views received from the main parties which offered them, focusing in particular on their responses to the Issues and Remedies Letters.
- (l) *Chapter 15—Views of other interested parties* summarizes the views and submissions received from interested parties.