

Markets for grocery retailing

1. In considering whether the relevant geographic market for grocery retailing is national or local, we discuss in this appendix:
 - retailers' internal assessments of the geographic scope of competition;
 - the scale of competitive initiatives by grocery retailers at the national and local level;
 - the possibility of chains of substitution between different local markets for the supply of groceries; and
 - the impact of web-based grocery shopping on the geographic market.

We also refer to our analysis in Appendix C of the impact of new store entry on the revenue of incumbent stores located varying distances away.

2. To evaluate the effect of a horizontal merger, we define the relevant market by applying the SSNIP test, which is a conceptual framework. In principle, we define a market for each product of the merging firm. In some situations, the market definition may produce different markets depending on the starting point. However, in the present case the Tesco Brunel Way store and the acquired store located in Uxbridge Road are not only geographically very close to each other, but they are also two large stores, offering a full-range of grocery products. We consider that the geographic market for both stores is likely to be the same.
3. The geographic market is defined by the distance to the furthest store in a collection of stores that effectively constrain the behaviour of the store from which we start the SSNIP test (ie the store at the centre of an isochrone). We include in the market the competitor stores that are close substitute to the centre store. In general, the relevant geographic market around a given store will vary according to the store size, fascia and location of the store at the centre of the isochrone, and there will be a degree of overlap between the relevant geographic market surrounding each store.
4. Consistent with previous inquiries, we continue to describe the relevant geographic market for the supply of groceries, particularly in the case of larger stores, in terms of drive-time isochrones. For the most part, consumers take their car when shopping. There is some expectation that the proportion of shoppers driving might decrease in the future given both environmental concerns and changes in shopping habits. However, for the purposes of our analysis, we consider that the use of a drive-time metric remains a useful means of expressing the size of the relevant geographic market for larger stores and capturing the distance over which competitive constraints operate between stores.

Retailer assessments of the geographic scope of competition

5. We have reviewed a number of internal documents from grocery retailers that provide an insight into how these retailers view the geographic scope of competition between different grocery outlets. These include:

- market research assessments; and
 - investment appraisals for new stores.
6. These documents are, for the most part, consistent with the submissions of the different grocery retailers in relation to how the relevant geographic market should be defined for the purposes of this investigation. M&S, Asda, Association of convenience stores (ACS), Pareto Retail Ltd, Sainsbury's, Morrisons, Somerfield and Waitrose all told us that the competitive constraints in grocery retailing were local, but with a number of parties also making reference to the presence of national, as well as local, competitive initiatives by retailers.
 7. Tesco, however, submitted that the relevant geographic market for the supply of groceries was national. Evidence and arguments submitted by Tesco in support of this view include a simulation model of the SSNIP test (see Appendix E), the presence of chains of substitution between local geographic markets (see paragraphs 11 to 18), and the predominance of national, as opposed to local, competitive initiatives by grocery retailers (see paragraphs 8 to 11).

National and local competitive initiatives by grocery retailers

8. It has been put to us that the prevalence of nationally set, and largely uniform, aspects of the retail offer for grocery stores indicates a national rather than a local geographic market. However, this is not necessarily the case as the extent of local competition may be an important input into national decisions regarding pricing and other competitive variables.
9. To illustrate with a simple example, consider two competing retailers each with a 50 per cent share of national sales. In the first scenario, both retailers have an equal share of sales in every local area. In the second scenario, each retailer has 100 per cent share of sales in half of the local areas. Competition between the two retailers will clearly be less intense in the second scenario, and it is reasonable to expect that national prices will be higher under this scenario.
10. Consistent with this, Asda told us that the extent to which it faced its competitors in different local markets across the UK had a clear impact on its national strategy, including price. It told us that:

To the extent there is a lack of local competition, we believe that is reflected in two ways. One, where the retail offers are set locally, that is likely to be reflected locally.¹ Secondly, to the extent PQRS are set nationally, we think that the aggregation of the local competition conditions will be reflected in the way those strategic parameters, if you like, were set nationally. So we think that local competition feeds through in both of those ways.²
11. It seems clear that as any one retailer increases its market share across local areas, constraints on its national prices may be weakened. That is, less intense local competition is likely to result in higher national prices. Even though many aspects of the retail offer, and price in particular, are set nationally, the extent of local competition is a key factor in determining outcomes for customers.

¹Asda described the retail offer as PQRS (price, quality, range and service).

²Asda main party hearing, Groceries market investigation.

Chains of substitution between local geographic markets

12. Tesco argued that chains of substitution between local markets were sufficiently strong to form a national market for grocery retailing. It provided maps (that it termed 'porcupine' maps) based on loyalty card data that suggest that the catchment areas of local Tesco stores overlap to the extent that they join up across the country. An example is set out in Figure 3.

FIGURE 3

'Porcupine' map of the South-West showing geographical origin of Tesco store revenues

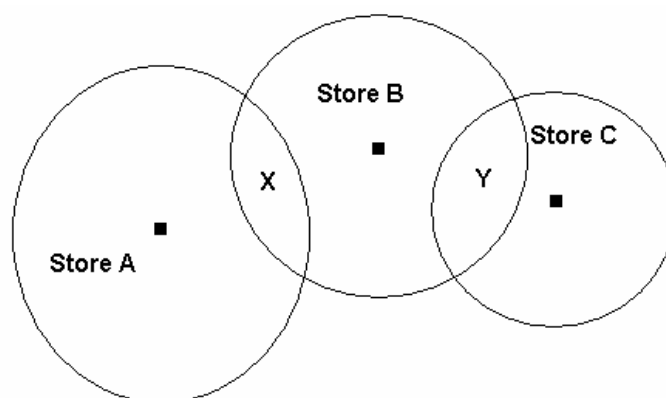


Source: Tesco

13. The intuition for the chain of substitution argument is best introduced with an example. Figure 4 presents a simplistic example with three stores, A, B and C, each with a catchment area delineated by a circle around each store. Suppose we are interested in the relevant market for store A. To determine the closest substitute to store A, we assess the number of marginal consumers that would switch to rival stores following a price increase. In this example, store B is a direct substitute to store A, as a group of marginal customers represented by group X in Figure 4 would switch between the two stores.
14. To determine whether store A and B are part of a distinct geographic market, we then consider whether a hypothetical monopolist controlling stores A and B could profitably raise prices by 5 per cent. Consumers located in Y would likely switch to store C following the price increase, as store B also competes directly with store C. The hypothetical monopolist cannot profitably raise all prices by 5 per cent if the number of marginal consumers located in Y is sufficiently large. We must then include store C in the relevant geographic market. And although store A and store C are not direct substitute, they are part of the same market.
15. The SSNIP test ends when we have found a group of stores for which the monopolist can profitably raise prices. The chain of substitution argument therefore broadens the relevant geographic market by including stores that do not directly compete. In our example, stores A and C do not have overlapping catchment areas, but are part of the same market because of C's constraint on B.

FIGURE 4

A chain of substitution constraining the offer of stores A and C



Source: CC

16. There are several reasons why the chain of substitution argument may not broaden the market to a regional or national scope. First, the chain of substitution breaks down when there is discontinuity in the catchment areas. [X] However, it seems unlikely that, given the physical geography of the UK, there will be a sufficiently large number of competing stores located in close physical proximity to prevent any breaks in the chain of substitution.
17. Secondly, even where there are a large number of closely located stores, the chain of substitution effect fades with distance. The size of the marginal consumer group required to prevent the hypothetical monopolist from raising prices simultaneously in all stores will have to become larger and larger as the number of stores in the candidate market increases. This is because the amount of lost revenue to competitor stores, that constrain the price increase, will have to outweigh the revenue gains from increasing prices. In addition, the total revenue gains will increase with the number of stores in the candidate market, while the amount of lost revenue is a function of the size of the marginal consumer group. [X]
18. Thus even if stores (eg A to Z) are located at equal distance from each other, there will be some point where the marginal group of consumers between two stores, say E and F, will not represent a sufficient proportion of revenues of stores A to E to make a price increase across all of those stores unprofitable. In this case, there is a break in the chain of substitution such that store A would not be in the same market as store F.
19. Finally, the hypothetical monopolist test does not imply that prices at all stores in the candidate market must be increased. Going back to the example in paragraph 13, it is plausible that a hypothetical monopolist of stores A and B could exercise market power by only increasing the prices of store A and not store B. By doing so, store B captures the lost revenues from consumers diverting away from store A, and store C does not act as a constraint on the monopolist. This breaks the chain of substitution. For these reasons, we consider that 'chains of substitution' are unlikely to widen geographic market boundaries beyond local areas. This is consistent with findings in previous CC reports.
20. Tesco, however, has submitted the results of simulation model that purports to apply the SSNIP test. Tesco's model implements a large chain of substitution effect that

effectively widens the geographic market. In Appendix E we present our concerns with this exercise.

The impact of Internet-based grocery shopping

21. Internet shopping for groceries constitutes around 1 to 2 per cent of UK retail grocery sales. This seems likely to increase in the future although the extent of any increase is not clear. It is plausible that the emergence of Internet shopping may widen the geographic market for grocery shopping:
 - (a) According to Tesco, 98 per cent of the population can receive deliveries from Tesco.com, 48 per cent from Ocado, 76 per cent from Sainsbury's to You and 43 per cent from Asda at Home.³
 - (b) Online retailers typically deliver up to 30 minutes or more from the store.
 - (c) Some Internet retailers do not base their delivery service around particular stores ([X]). In such cases, the catchment area of the service is decoupled from store location and replaced by the geographical coverage that the deliveries from depots can provide.
22. However, in any future consideration of the impact of increased Internet grocery shopping on the size of the relevant geographic market, account also needs to be taken of whether Internet-based grocery shopping is in the same product market as grocery shopping at a store. Given the small size of Internet shopping at the moment, we have not looked at this issue in any detail. However, we consider that while the existence of Internet shopping may widen the precise boundaries of some local markets, these markets will still be local.

³We note that only 57 per cent of UK households have access to the Internet. Source: Office for National Statistics.