

**Impact of Supermarket Expansion in the
Convenience Retailing Sector**

**A Report for the Association of
Convenience Stores**

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31 May 2005

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
1 INTRODUCTION.....	3
2 THE MARKET	5
Market definition	5
Market overview	8
3 THE COST OF ENTRY.....	18
4 COMPETITION ISSUES.....	22
What commercial advantages do supermarkets have?	22
Upstream buyer power	25
Independent buying groups and wholesalers	37
5 CONCLUSION	42
APPENDIX 1: SYMBOL GROUP OPERATION: THE OFFER OF P&H	
APPENDIX 2: PROPERTY PRICES	
APPENDIX 3: ACKNOWLEDGMENTS.....	

EXECUTIVE SUMMARY

We consider that the relevant economic market is likely to be the market in convenience retailing, encompassing convenience sales in supermarkets and other larger grocery stores as well as sales in dedicated convenience stores. Market definition based on store size or type is unsatisfactory.

The presence in convenience retailing of supermarkets and other operators of large multiple stores is far larger than the number of convenience stores that they own might suggest. We estimate convenience retailing to be worth about £41 billion per annum, and that convenience sales in supermarkets and other stores over 280 square metres account for some 44 per cent of this market.

Our analysis suggests that the primary competition problem in convenience retailing is the exercise of buyer power by supermarkets. In our view, the distortion to competition occasioned by such buyer power is already sufficient to warrant concern by the competition authorities. If supermarket expansion in convenience retailing continues unchecked, the effects will be exacerbated.

Distortions to competition manifest themselves in several ways:

- First, supermarkets have an advantage over other players which arises from the exercise of market power in purchasing groceries rather than from greater efficiency. This distorts competition between grocery retailers, thus moving the market away from the efficient, competitive outcome. Hypothetically it is possible that independent stores which are more efficient, better located or more innovative than rival supermarket-owned stores could lose trade or even go out of business as a result of supermarkets' ability to obtain better buying terms from suppliers through the exercise of market power.
- Second, and assuming an effectively competitive supply sector, consumers will pay more for their groceries overall unless supermarkets pass on to their customers 100 per cent of their buying advantage. This is because of the so-called "waterbed effect" which arises because the market for the wholesale supply of groceries will adjust, following the exercise of supermarket buyer power, until suppliers recover from weaker non-supermarket buyers the margins they lose to supermarkets. We have calculated that under certain (speculative) assumptions, consumers could end up paying £1 billion more every year for their groceries as a result of supermarket buyer power.
- Third, as independent buying groups and wholesalers lose scale to supermarket expansion, they further lose buying power and economies of scale relative to supermarkets. This weakens the viability of independent wholesalers; that weakness is visited upon independent retailers; and the competitive constraints that the independents can exert on supermarkets is likewise weakened. The acquisition of convenience store groups by supermarkets has the potential to bring about precisely this sequence of effects.

- Fourth, it is possible that the supermarkets' search for expansion in convenience retailing is driving up the price of sites or of established businesses to an extent which represents a barrier to expansion for viable independent players. The evidence we were able to gather on this point is not conclusive, but we suggest it should be covered in a wider market investigation.
- Supermarkets may be able systematically to practise below-cost selling. We emphasise, however, that evidence on this point is to be presented separately and directly to the OFT by the Association of Convenience Stores.

In our view, the "waterbed effect" does not imply that suppliers consciously raise prices to non-supermarket buyers in order to recover profits (if they did, that would imply market power on the part of suppliers, and we have no evidence of that). Rather, we believe that the "waterbed effect" occurs through the dynamics, and in this case the distortions, of a competitive market.

Our analysis suggests that convenience stores are not a homogenous phenomenon. Although the OFT has said in on a number of occasions that it regards "the convenience store sector" as having low barriers to entry, we suggest it needs to consider whether this is actually true for the larger convenience stores that are attractive to multiples; and if not, whether this limits the capacity for expansion of players who enter at the lowest level.

Our conclusion is that a market investigation is called for under the Enterprise Act 2002.

1 INTRODUCTION

- 1.1 This report by Europe Economics was commissioned by the Association of Convenience Stores (ACS) and looks at the impact of supermarket expansion in the convenience retailing sector.
- 1.2 In a recent document setting out the findings of an audit of supermarkets' compliance with the Supermarkets Code of Practice, the OFT requested evidence on "wider competition issues" in the grocery market.¹ This follows suggestions that the OFT should make a market investigation reference to the Competition Commission (CC).
- 1.3 In more detail, the OFT invited evidence on:
- (a) The practical effect of various structural developments (including the entry of Tesco and Sainbury's into the convenience store sector) on buyer power and hence on:
 - competition between grocery retailers; and
 - competition between suppliers to compete for the business of grocery retailers;
 - (b) The cost of entry to the convenience store sector, and the extent to which it has been affected by the entry into the sector of the supermarkets;
 - (c) The nature and prevalence of below-cost selling and price flexing, and any adverse effects on competition they may have;
 - (d) Whether competition is being prevented, restricted or distorted as a result of the entry of large supermarkets into the convenience store sector, such that consumers are worse off as a result of such developments.
- 1.4 In 2000 the CC conducted a market investigation into the supermarket sector. However, this review occurred before the more recent growth in the number of convenience stores owned by leading supermarkets, and did not examine competition issues in the convenience retailing market.
- 1.5 Europe Economics was commissioned by ACS to analyse and report on the impact of supermarket expansion in the convenience retailing sector. The project involved discussions with key players in the sector, examination of data on store purchase prices and analysis of competition issues. ACS has separately gathered evidence on below-cost selling.
- 1.6 This report sets out Europe Economics' findings and is structured as follows:

¹ OFT (2005), "Supermarkets: The code of practice and other competition issues", March

Introduction

- (a) Section 2 briefly discusses the issue of market definition and gives some background on the convenience retailing sector;
- (b) Section 3 looks at the impact of supermarkets on the cost of entry;
- (c) Section 4 discusses some of the competition issues which arise;
- (d) Section 5 concludes;
- (e) Appendix 1 gives an example of a symbol group offering; and
- (f) Appendix 2 gives further details of our analysis of property prices.

2 THE MARKET

Market definition

- 2.1 The starting point for competition analysis is generally to define the relevant market within which competition takes place. This has two dimensions: the *product* market and the *geographic* market.
- 2.2 A detailed examination of market definition based on econometric analysis is outside the scope of this study. Therefore, we have considered a number of market definitions, including those employed by the OFT and the CC, in order to arrive at a working definition suitable for use in a response to the OFT's current consultation.

The CC approach

- 2.3 In its 2000 report on supermarkets, the CC sought to define supermarkets rather than other types of store. In the process the CC relied on a binary definition of consumers' grocery shopping behaviour as "one-stop" or "top-up" and defined supermarkets as stores of 1,400 square metres (15,000 square feet) or above providing one-stop grocery shopping. The CC concluded that Asda, Morrison, Safeway, Sainsbury's and Tesco were "able to exercise power in this market".²
- 2.4 Subsequent competition investigations in the grocery sector, principally the Morrison's acquisition of Safeway, have led to refinements of the definitions used in 2000.³ Here the CC stuck with its reliance on the concept of "one-stop" shopping and with its definition of supermarkets as stores above 1,400 square metres providing one-stop shopping, but it sub-divided smaller stores into convenience stores (up to 280 square metres) and other stores (between 280 and 1,400 square metres) which were seen as providing "secondary" or "top-up" shopping.

The OFT approach

- 2.5 In our view the OFT has usefully developed relevant market definitions, principally by recognising that the behaviour of consumers is of greater relevance to market definition than the floor areas of different types of stores.
- 2.6 Thus, in assessing the acquisition of T&S Stores and Adminstores by Tesco and the acquisition of Jacksons by Sainbury's, the OFT argued as follows:

"The appropriate frame of reference for considering the competition constraints would ... appear to be **convenience retailing, including secondary shopping from**

² *Supermarkets*, CC, October 2000, Cm 4842, paragraph 1.5.

³ *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc*, CC, October 2003, paragraph 1.8.

supermarkets [*our added emphasis*] but excluding small shops that do not meet the Mintel/IGD criteria [for definition as convenience stores]"

- 2.7 The important point here is recognition that supermarkets compete with other smaller stores for convenience shopping, and that the market definition therefore needs to encompass convenience retailing both in convenience stores and in supermarkets. In its assessment of the T&S acquisition, the OFT quoted an estimate by Tesco that around 15-25 per cent of spending in its supermarkets could be characterised as secondary shopping.
- 2.8 As for the geographic market, the OFT discussed both national and local elements to convenience retailing.
- 2.9 In analysing whether acquisitions of convenience stores might give rise to competition concerns at a local level, the OFT sought to identify individual stores where the number of competing outlets in the local area (whether convenience stores or supermarkets) would be reduced to two or less as a result of the acquisition. In its assessment of the T&S acquisition, the OFT assumed that convenience stores had a catchment area of one mile radius. In subsequent cases, this was refined and a smaller catchment area of half a mile radius was used for stores in densely populated areas.
- 2.10 In assessing the impact of acquisitions on upstream buyer power, the OFT has in the past looked at the market for all grocery supplies (at a wholesale level).

Approach used by IGD and others in the industry

- 2.11 The Institute of Grocery Distribution (IGD), along with others in the industry, uses the more restricted definition of "retailing in convenience stores". Thus, in its report on consolidation in convenience retailing, the IGD's statement that "the UK convenience grocery retailing sector currently generates sales of £23.0bn per annum" does not take account of convenience shopping in supermarkets.⁴
- 2.12 The criteria that IGD uses in deciding whether a retail outlet counts as a convenience store are as follows:
- (a) First, the store must be below 280 sq m (3,000 sq ft), as stores greater than this size are prohibited by law from opening for more than 6 hours on a Sunday;
 - (b) Second, the store must sell retail food and drink, for consumption off the premises, as its main business activity;

⁴ IGD, *Consolidation in Convenience Retailing: Examining the Implications*, December 2004, p.171.

(c) Third, the store must sell at least eight out of a list of fifteen core product categories.⁵

2.13 IGD's approach in this particular report does not seem to be intended as a formal definition of the market for competition purposes; however, it is important to be aware of what market IGD is referring to when figures from its report on consolidation are quoted.

2.14 IGD also distinguishes different types of shopping activity that take place in convenience stores.⁶ It refers to three – top-up shopping, distress shopping and impulse shopping.

The ACS approach

2.15 A number of groups involved in the industry, including the ACS, the Federation of Wholesale Distributors (FWD), Friends of the Earth, and the National Federation of Women's Institutes (NFWI), have argued that the grocery market should be considered as a whole.

2.16 For example, the ACS has stated its position as follows:

“ACS strongly believes that the grocery market locally and nationally should be considered as a whole, rather than as two distinct market categories: “one stop” and “top-up”. ACS is concerned that this distinction fails to account for modern shopping habits, in which stores falling into both categories include a high proportion of top-up shopping. This is illustrated by the fact that top-up shopping accounts for £26bn in superstores – a higher figure than the total size of the convenience market at £21.5bn.”⁷

2.17 In contrast to the OFT's market definition, the ACS approach would encompass all grocery sales at supermarkets (rather than just the proportion of supermarket grocery sales classified as convenience shopping).

2.18 If ACS' market definition were to be used, it would give rise to a number of implications for the analysis of competition issues, in that:

(a) The supermarkets' share of the whole retail market for groceries would be less than their share of “one-stop” grocery retailing but greater than their share of convenience retailing; and

(b) Supermarket acquisitions of convenience stores would have a smaller impact on their share of the whole market.

⁵ Alcohol, confectionery, fast-food/food-to-go, fresh fruit/vegetables, frozen/chilled foods, household/non-food, milk/dairy, National Lottery (any game), newspapers/magazines, bread/bakery products, health and beauty aids, packaged groceries, savoury snacks, soft drinks, and tobacco.

⁶ IGD, *Consolidation in Convenience Retailing: Examining the Implications*, December 2004

⁷ ACS submission to OFT on Adminstore, Feb 2004; <http://www.thelocalshop.com/default.asp?Call=Article&Search=&ID=3062>. ACS has informed us that the figure quoted for the value of the convenience market relates to 2003 (IGD).

Market definition used in this report

- 2.19 The primary question is therefore whether “convenience retailing” is a relevant economic market. For the purposes of this report, we have assumed that it is. Such a definition is implicit in the CC’s distinction between “one-stop” and “top-up” shopping and in the IGD’s three sub-divisions mentioned above. It is explicitly recognised by the OFT in its analyses of the supermarket acquisitions of T&S, Adminstore and Jacksons. It is also implicit in the second two sentences of the ACS quotation above.
- 2.20 We have not, however, carried out a formal market definition exercise, so this should not be taken as a definitive statement of our view.

Market overview

Market size

- 2.21 The UK retail market for all grocery retailing in 2004 was assessed at £115 billion.⁸ The extent of retailing through convenience stores for 2004 was assessed by the IGD at £23 billion, leaving £92 billion as the retail revenue flowing through supermarkets and all other stores above 280 square metres. As we have already reported, the OFT recorded in its assessment of the acquisition of T&S a comment from Tesco that between 15 and 25 per cent of its sales at retail level (the precise figure was confidential) were classified as secondary shopping. If we assume the actual figure is 20 per cent, and that it also applies to other multiples, then we might surmise that the supermarkets and other groups owning stores above 280 square metres have convenience retailing revenue of about £18 billion.
- 2.22 In very round terms, therefore, we assess the turnover in convenience retailing at about £41 billion per annum.
- 2.23 IGD reports that recent revenue growth in convenience stores has substantially outstripped growth in grocery sales overall. Between 2003 and 2004, convenience store sales grew by 7.3 per cent compared with 3.3 per cent for grocery as a whole.

Types and market shares of players

- 2.24 IGD breaks the convenience store sector down into five types of player:
- Non-affiliated independents;
 - Symbol stores (those which operate under common fascias, some franchised, some owned by the symbol owner);

⁸ Source IGD

- Forecourts (stores on the forecourts of filling stations);
 - Convenience multiples (including convenience stores owned by supermarkets as well as by groups which might own wholesaling and distribution facilities as well as retail shops);
 - Co-operatives.
- 2.25 To these categories we add supermarkets and other stores above 280 square metres, on the grounds that they represent, at least for some consumers, outlets for convenience shopping.
- 2.26 IGD estimates the share of revenue of each type of outlet, based on total revenue of £23 billion. If we add £18 billion of revenue to cover convenience shopping in supermarkets and other stores above 280 square metres, and adjust all other market shares to reflect the greater size of the market, the following shares emerge:

Table 2.1: estimated convenience retail revenue by outlet type

Outlet type	Estimated sales (£m) 2004	Estimated share (per cent)
Non-affiliated independents	9,255	22
Symbols	5,709	14
Forecourts	3,637	9
Convenience multiples (note 1)	2,256	6
Estimated convenience shopping in supermarkets and other stores above 280 square metres	18,000	44
Co-operatives	2,187	5
Total	41,000	100

Note 1: Convenience multiples include convenience stores owned by supermarkets, but not those owned by Co-ops, which are shown separately, two rows below

Source: Europe Economics from IGD and OFT sources

- 2.27 Table 2.2 gives a breakdown of numbers of stores by type.

Table 2.2: numbers of convenience retailing outlets by category

Outlet type (note 1)	Estimated number 2004	Share of total (per cent)
Non-affiliated independents	28,220	47
Symbols	12,780	21
Forecourts	9,401	16
Convenience multiples (note 2)	2,213	4
Supermarkets and other stores above 280 square metres	6,372	11
Co-operatives	2,321	3
Total	60,281 (note 3)	100

Note 1: The source for all entries is IGD, except for the total of supermarkets, for which the source is TNS.

Note 2: Convenience multiples include convenience stores owned by supermarkets, but not those owned by Co-ops, which are shown separately, two rows below.

Note 3: Net of 1,026 joint ventures reported by IGD.

2.28 From Tables 2.1 and 2.2 we can derive average revenues by type of store, as set out in Table 2.3. The wide range of revenues is striking.

Table 2.3: average revenue by outlet type

Outlet type	Total estimated revenue (£m) 2004	Estimated number 2004	Average revenue per outlet (£ p.a.)
Non-affiliated independents	9,255	28,220	328,000
Symbols	5,709	12,780	447,000
Forecourts	3,637	9,401	387,000
Convenience multiples	2,256	2,213	1,020,000
Estimated convenience retailing in supermarkets and other stores above 280 square metres	18,000	6,372	2,820,000
Co-operatives	2,187	2,321	1,060,000
Total	41,000	60,281	683,000

Source: Europe Economics from IGD, TNS, OFT

Ownership of convenience stores by multiples

2.29 The ownership of convenience stores (i.e. those under 280 square metres) by the multiples is easily summarised. In the following discussion, we include references to garage forecourts operated in partnership with petrol retailers (note that these would come under “forecourts” rather than “convenience multiples” in IGD’s breakdown of the

market). In addition, some supermarkets also own garage forecourts on filling stations attached to their own supermarkets, and these are not listed below.

2.30 Ownership, in descending order of numbers of stores, is as follows:⁹

- (a) Tesco owns 1,078 convenience stores (a combination of Tesco Metro, Tesco Express, together with One Stop and Day & Nite shops acquired from T&S and undergoing conversion to a Tesco format). Tesco thus owns 46 per cent¹⁰ of convenience multiples if we exclude those operated by the co-operatives, or 23 per cent¹¹ if we include them. Tesco operates 130 forecourt shops in partnership with Esso.
- (b) The Co-op Group owns 1,293 convenience stores (and other individual co-ops a further 1,028). Although we recognise that the commercial basis on which co-ops work is in some respects different from that of other trading organisations, we do not believe that, for purposes of market definition or segmentation, co-op owned convenience stores represent a separate element.
- (c) Sainsbury's owns 282 convenience stores, and operates 24 forecourt shops operated in partnership with Shell.
- (d) Morrisons involvement in the convenience sector appears limited to 61 forecourt shops (originally Safeway) operated in partnership with BP.

2.31 In the forecourt segment the oil companies themselves are the largest owners of forecourt convenience stores: Esso owns 680, Total 548 and Shell 524. Tesco is by some way the leading grocery multiple in forecourts, with 502 stores in ownership or partnership. Nevertheless, even Tesco has only 5 per cent of the 9000+ forecourt convenience stores in operation. The forecourt segment remains relatively unconcentrated.

2.32 In the convenience store sector overall, Tesco, the Co-op Group and Sainsbury's are the largest players among the multiples.

2.33 The Co-op Group, which had owned and operated convenience stores for some years previously, acquired Alldays in 2002, then Balfour in 2003, and Conveco in 2004. The effect of these acquisitions, even after some disposals, more than doubled the Co-op Group's presence in the sector.

2.34 In Table 2.4 below we summarise by fascia (shop name as it appears to consumers), in descending order of numbers of stores, convenience stores which are owned by

⁹ Source: IGD

¹⁰ Calculated as 1,078 divided by 2,333 (the total number of multiple-owned stores given in Table 2.4).

¹¹ Calculated as 1,078 divided by the sum of 2,333 (the total number of multiple-owned stores given in Table 2.4) and 2,321 (the total number of co-op stores given in Table 2.2).

multiples. Table 2.4 shows that three multiple groups – Tesco, Somerfield and Sainsbury's – together own over 70 per cent of stores in this category.

Table 2.4: convenience multiple stores ranked by fascia

Convenience Multiples	Number	Per cent
Tesco Express / Metro	547	23.4
One Stop / Day & Nite (Tesco)	531	22.8
RS McColl / McColl / Somerfield JVs (TM Retail)	305	13.1
Smile Local (T&A Symonds)	110	4.7
Amigo / Whistlestop (SSP)	85	3.6
Mills	82	3.5
Simply Food (M&S)	76	3.3
Somerfield	71	3.0
Sainsbury's Local	57	2.4
Bells (Sainsbury's)	55	2.4
Budgens (Musgrave)	54	2.3
Huttons (Thresher Group)	33	1.4
D Sands	17	0.7
Jones Day & Night	15	0.6
Artgoal	14	0.6
AM Landsburgh	9	0.4
JB Beaumont (Sainbury's)	6	0.3
Others	153	6.6
Total	2333	100.0
Total Tesco	1078	46.2
Total Sainsbury	231	9.9

Note: The One Stop and Day & Nite stores were part of the T&S group acquired by Tesco. We understand that Tesco is converting the majority of these stores to a Tesco fascia and format.

Source: IGD

Supermarket acquisitions

2.35 Tesco and Sainsbury's have established their respective positions relatively rapidly. Tesco acquired T&S Stores in early 2003, and Adminstore in 2004. Sainsbury's acquired Jacksons in 2002, J B Beaumont and Bells Stores in 2004 and SL Shaw in 2005. None of these transactions was referred to the CC.

2.36 Table 2.5 gives more details of supermarket acquisitions in the convenience store sector. It lists the parties involved and some financial statistics on the acquired business. (This information is also used in some of the calculations described in section 3.)

Table 2.5: supermarket convenience store acquisitions

Date	Active business	Target business	Number of stores	Price (£m)	Profit (£m)	Turnover (£m)	Area (thousand sq ft)
Jan-03	Tesco	T&S Stores	1,215	520	933		46
Feb-04	Sainsbury's	Bells Stores	54	21.5	56	108	1
Mar-04	Tesco	Adminstore	45	53.7	72.8		2.1
Aug-04	Sainsbury's	Jacksons	114	100	143	214	
Nov-04	Sainsbury's	JB Beaumont	6		13		
Apr-05	Sainsbury's	SL Shaw	5		11		

Note: These figures are subject to the caveats discussed in the appendix and are taken from published sources including IGD, company press releases and annual accounts, and Christie & Co estate agents Business Outlook 2003, 2004, and 2005.

2.37 Tesco's desire to accelerate its growth is reported in its Annual Review and Summary Statement 2004.

"We have a strong and accelerating organic growth strategy in the convenience market. Next year we will open 31 new stores and convert 194 T&S stores, giving us a total of over 500 convenience shops."

2.38 IGD discusses the future of Tesco's presence in the sector as follows:¹²

"Meanwhile, the conversion of selected *One Stop* and *Day & Nite* stores to the Tesco *Express* format is moving quickly and, at the time of writing (November 2004), the average rate of conversion stands at 3.2 stores per week, a remarkable pace which demonstrates not only Tesco's major capital advantage but also its commitment to the convenience store concept and its ability to manage the complex, large-scale store development projects.

It is anticipated that about 500 ex-T&S stores will remain under the *One Stop* fascia and that these will eventually be supplemented through an opening programme of 20-25 new stores per year."

2.39 IGD estimate that even without any further acquisitions Tesco will increase its convenience store sales by 55 per cent in five years. With regard to the possibility of future acquisitions, IGD report the following:

"Terry Leahy, Tesco's Chief Executive used a speech he gave in October 2004 to play down the possibility of any further major acquisitions in convenience sector, stating that future development would be primarily through organic means." (p.60)

¹² IGD, Consolidation in Convenience Retailing: Examining the Implications, December 2004, p59

- 2.40 Sainsbury's are also developing their position in convenience retailing and are attempting to achieve substantial increases in turnover in the sector as outlined in their Business Review October 2004.

“Convenience stores provide local shopping for customers to access Sainsbury's offer and it is estimated that sales will grow by £400 million over three years to the end of 2007/08.”

- 2.41 The IGD predicts Sainsbury's convenience store turnover will increase by two-thirds in five years even if there are no further acquisitions (this was before the purchase of SL Shaws). The report says (p130):

“Sainsbury's has stated that it intends to increase its convenience sales from just over £400m to £800m over the next three years. Part of this will be offset by Sainsbury's broader definition of convenience retailing (IGD has excluded certain stores from this analysis) but even so, with the current portfolio, this will be a very stretching target and Sainsbury's must surely be on the lookout for additional acquisitions if it is to meet its target.”

- 2.42 During our discussions with convenience sector stakeholders, most expected that the supermarkets' growth in the convenience sector would continue as far as the competition authorities would allow it.

Ownership of convenience stores by independents

- 2.43 The ownership of convenience stores by non-multiples is more complex, primarily because of the existence of a separate wholesaling function which is not present among the supermarket groups.
- 2.44 Some independent groups own retail stores only, others own wholesaling operations as well as retail shops, others operate “symbol” or franchise arrangements, and some are affiliated to buying groups.
- 2.45 The term “symbol” in convenience retailing denotes a relationship between a shop owner and a buying or wholesaling group in which the latter provides not only goods but also a variety of support functions – particularly branding. The relationship may, but need not necessarily be, a franchise arrangement.
- 2.46 In Table 2.6 below we rank convenience stores in the symbols and franchises category, again as determined by IGD, and again ranked by numbers of stores.

Table 2.6: symbol group and franchised fascias, ranked by numbers of stores

All stores belonging to a symbol or franchise, by fascia	Number	Per cent
Spar UK	2,737	22.1
Londis (Musgrave)	2,248	18.2
Premier (Booker)	1,817	14.7
Costcutter	1,300	10.5
Lifestyle / Scandia (Landmark)	1,190	9.6
Best In / Best One (Bestway)	652	5.3
Day Today (Nisa-Today's)	650	5.2
Key Store / Shop (Key Lekkerland)	350	2.8
Nisa (Nisa-Today's)	300	2.4
Supershop (P&H Retail)	207	1.7
Mace (P&H Retail)	199	1.6
Mace Express (P&H Retail)	189	1.5
VG / Vivo (Northern Ireland)	140	1.1
Your Store (P&H Retail)	115	0.9
Centra (Musgrave Group NI)	77	0.6
Thoroughgoods - franchise (Bargain Booze, BWG)	70	0.6
Budgens / Budgens Local (Musgrave)	51	0.4
Quix (NFRN)	50	0.4
Todays (Nisa-Today's)	30	0.2
Somerfield	13	0.1
Total	12,385	100.0
Total Musgrave	2,376	19.2
Total Nisa-Today's	980	7.9
Total P&H Retail	595	4.8

Note: There are a number of other smaller symbol groups not included in the above table.

Source: IGD

2.47 A comparison of Table 2.6 with Table 2.4 shows that symbol groups form an important segment of the convenience store sector. They account for 21 per cent of all outlets that provide convenience shopping, and are the second largest single segment, after the 28,000+ independent, non-affiliated stores.

2.48 The largest players in symbol group stores are briefly described below.

- (a) SPAR is an international organisation, Dutch in origin, which has been active in the UK since 1957. It is currently the largest UK symbol operation measured by number of stores.

- (b) Musgrave is an Irish-based company which owns Londis in the UK. Londis is an entirely symbol operation. Musgrave has extensive wholesaling activities in Ireland, but none in the UK. Because Musgrave owns the 54 Budgens stores (which are not a symbol group operation) the name Musgrave appears in Table 2.5 as well as in Table 2.6. In 2004, Musgrave's group revenues amounted to some €3.4 billion.
- (c) Booker, a UK-based company, has traditionally been a wholesale distributor and cash-and-carry supplier for small convenience store owners and caterers. In addition, it has for nearly 20 years operated a retail symbol group under the name Premier, which it has recently reinvigorated.
- (d) Costcutter (Costcutter Supermarkets Group Limited) is likewise a substantial, well-established symbol group operation which, according to its website, works with stores from 500 square feet up to 5,000 square feet. Costcutter also offers the Costcutter Express opportunity, which it claims is well suited to forecourt stores of under 1,000 square feet. For its procurement activity Costcutter is a member of the Nisa-Today's buying group, which we turn to next.
- (e) Nisa-Today's, a UK-based company located in Scunthorpe, is a buying group, wholesaler and symbol group operator, owned entirely by its members, of which there are now, according to its 2004 Report and Accounts, more than 800. Nisa-Today's claims to be the industry's largest independent buying consortium. Its own revenues amounted in 2004 to just under £1 billion.
- (f) P&H (formerly Palmer and Harvey McLane) provide buying and retailing support to independent convenience store owners. Its website lists several types and levels of support to different types and sizes of store. The P&H symbol group offering is clearly and succinctly set out on its website, and we have therefore reproduced part of the "About P&H Group" web page as Appendix 1 to this report as an illustration of how symbol groups work.

Conclusions arising from market structure

- 2.49 It is clear from the foregoing paragraphs that the convenience store sector is not a homogeneous entity. It encompasses a wide diversity of ownership, type of operation and revenue per store (and, indeed, revenue per square foot of store). In addition, the buying/wholesaling function for convenience stores, other than those owned by multiples, forms part of the convenience sector. There is thus a mutual dependence of convenience retailers on convenience wholesalers and *vice versa*. If one level in the supply chain is weakened the effect is inevitably going to be felt in the other. These features seem to us important in the context of a competition analysis.
- 2.50 We observe a quite sharp dividing line in terms of average revenue between the smaller players in the sector (the non-affiliated independents and the symbol group stores) and the larger players, particularly the stores in multiple ownership. As Table 2.3 makes clear, the convenience multiples and those owned by co-ops (which we suggest are effectively in the same segment) achieve average annual revenue of over £1 million per store. The

supermarket multiples achieve an average of nearly £3 million in convenience sales per annum per store. By contrast, the non-affiliated independents and the symbol group stores achieve average revenues of £328,000 and under £447,000 respectively.

- 2.51 The OFT has on a number of occasions said that it regards the convenience store sector as having low barriers to entry. If, as we suggest, the sector is far from homogeneous, competition analysis needs to take into account whether the barriers are low at every level in the sector, and, if not, whether there are barriers to expansion for those players who enter at the lowest scale. We develop this line of analysis further in Section 3.
- 2.52 Our description of the sector also suggests that, in the context of acquisitions by supermarket multiples of the larger independent convenience store operators, the viability of the wholesaling function needs to be part of the wider competition analysis. It seems to us intuitively likely that, as the larger convenience stores drop out of the wholesale supply chain by virtue of becoming part of a supermarket supply chain, the wholesaler left behind is weakened by loss of retail volume and by the diminished buying power that the loss of volume entails. The wholesaler's weakness is then visited upon the remaining retailers in his supply chain.
- 2.53 It may be argued that wholesalers (and indeed retailers) may then offset some or all of their disadvantages by consolidation among themselves. No doubt some economies can thereby be achieved, but it is for closer examination to determine whether they would be sufficient to sustain an effectively competitive convenience retailing sector. Apart from the question of whether a tendency towards monopoly in convenience sector wholesaling is a good thing from a competition or consumer point of view, the fact remains that, even if all independent convenience store buying were consolidated into a single entity, it would still be less in value than that of Tesco alone (at £23 billion retail equivalent *versus* roughly £30 billion) and would account for no more than 20 per cent of all grocery purchases (at £23 billion *versus* £115 billion). We examine the question of buyer power differences in more detail in Section 4.

3 THE COST OF ENTRY

3.1 The cost of entry into the convenience store sector, and the extent to which it has been affected by the entry into the sector of the supermarkets, was one of the central issues raised by the OFT for consultation.

3.2 Hitherto the OFT has taken the view that, in the event of relatively high local concentrations following supermarket acquisitions of convenience chains, anti-competitive conduct would be alleviated by the entry (or threat of entry) of rival firms.

“the OFT believes, having weighed up all the evidence before it, that actual and potential entry is capable of exerting an important competitive constraint on the parties post-merger.”¹³

3.3 There has been increasing concern within the independent convenience store segment that supermarket entry has raised site prices. Estate agents Christie and Co discuss the impact of consolidation in the sector as follows:

“Retail values rose 4.5% during 2004, according to Christie & Co’s index, with prices rising particularly strongly in the convenience store sector. However, because of the heady prices being paid by groups to acquire competitor chains, independent c-store operators have been given an inflated idea of the value of their stores. Acquisitive corporate operators are prepared to pay a higher price per store in order to acquire groups and thereby secure a significant increase in market share.”¹⁴

3.4 This quote suggests that the prices being paid in acquisitions may be above normal market rates and that this has caused a strong increase in prices across the sector.

3.5 We have been advised by ACS that convenience store businesses are sometimes offered for sale to supermarkets bilaterally, without being placed on the open market.

3.6 However, while prices for retail property in general and for convenience stores in particular have risen rapidly over the last couple of years, it is arguable that the trend may reflect other factors, including sharp and well-documented rises in residential property prices. Many small convenience stores come with accommodation, and the value of such accommodation may well be important in determining the value of the business. (There is, of course, nothing to prevent a buyer interested only in the shop from selling off the accommodation.)

¹³ OFT (2004), “Completed Acquisition by J Sainsbury plc of Jacksons Stores Ltd”, p7

¹⁴ Christie and Co (2005), “Business outlook”, <http://www.christie.com/christie/index.asp>, p18

- 3.7 The cost of fitting out a store adds a significant amount to the purchase price and therefore to the cost of entry. For example, IGD reports that Tesco's capital spend to convert the 45 ex-Adminstore sites to Tesco formats will be £10-15m.¹⁵
- 3.8 It does not necessarily follow, however, that high capital costs represent a barrier to entry. If there is no market distortion, high capital costs simply represent the true economic value of inputs required to compete in the market. It is possible that a substantial number of players are able to finance substantial up-front costs. Alternatively, if a business is expected to maintain its value after acquisition such that the owner is able to sell the business with minimal capital loss then entering the market would not result in a large net cost (after exit). Thus there would be relatively low barriers to entry. Costs of entry and exit both need to be considered.
- 3.9 As the cost of entry increases then the reliance of independent convenience store operators on borrowed finance increases. Lenders will typically charge a higher rate for a sole trader than they would for a large supermarket. As the quantity of borrowing rises the effect of the difference in interest repayments on rates of return is increased. Thus if the cost of entry rises supermarkets will enjoy greater benefit from their economies of scale in financing.
- 3.10 The rising cost of retail premises would be a cause for concern if the supermarkets were deliberately seeking to drive up property prices in the convenience sector to an artificially high level in order to prevent independent firms from competing.¹⁶ This strategy would be particularly effective if independent firms tend to lease premises whose rents rise in line with property prices, and if there were some obstacles, such as credit availability, to small independent firms re-entering the market once they have been driven out. When suitable sites are scarce and the supermarkets are significant buyers of these sites, artificially raising prices in this way becomes possible. However, we have no evidence to suggest that any of the supermarkets are pursuing a deliberate strategy of this nature.
- 3.11 Having undertaken some research into the commercial property market and spoken to convenience store operators, we suggest that the market for acquiring convenience stores may have two segments:
- (a) The numerically larger segment consists of owner-occupied premises (or "lifestyle businesses") which are often sold with adjoining accommodation and involve the owner in working long hours. These are typically smaller sites that would not be of interest to supermarkets (or even larger convenience multiples) because their turnover is too low to provide any profit once the costs of employing third party staff are taken into account.

¹⁵ IGD, *Consolidation in Convenience Retailing: Examining the Implications*, December 2004, p61

¹⁶ See Dobson P, Waterson M, Chu A, (1998) "The welfare consequences of the exercise of buyer power" OFT research paper 16, p24.

- (b) The other, smaller segment consists of larger convenience store premises in the best locations which have sufficient turnover to attract corporate buyers.
- 3.12 One contact we spoke to suggested £1 million per year turnover as the threshold dividing these two segments, but added that supermarkets have often (at least initially) sought sites that can generate (after renovation, itself an expensive step) over £2 million per year turnover.
- 3.13 We would expect supermarkets to have far more influence on site prices in the high-turnover segment of the market. It has also been suggested to us that this segment shows more similarity to larger grocery stores, including in terms of barriers to entry.
- 3.14 Europe Economics has looked into purchase prices but has found it difficult to assess, with any confidence, the effect on prices of the supermarkets. There are a large number of other factors which affect purchase prices.
- 3.15 Looking at a cross-section of figures we nevertheless found it possible to make some broad generalisations:
- (a) The supermarkets do not appear to have valued the businesses they bought at higher price-earnings ratios than other corporate buyers (although the behaviour of other firms in paying these prices could have been influenced by the supermarkets' entry). The supermarkets pay more on average per store but this is, *prima facie*, because they select the most profitable businesses to acquire. However, the number of transactions on which reliable data were available was limited. Further information is provided in Appendix 2.
- (b) Based on the information available (mostly from business advertisements) the price-earnings ratios of small convenience stores appear to be far lower than in the market for larger stores where Tesco and Sainbury's have made acquisitions. However, these profit estimates do not appear to make any allowance for the cost to the business of the owner's time.
- 3.16 Our initial conclusion is that the supermarkets are not systematically paying more than other bidders. It is *possible* that supermarkets have driven up the going rate for all bidders, but, given wider changes in property prices, it is difficult to be sure.
- 3.17 We have considered how barriers to entry may differ between large and small convenience stores. It is likely that barriers are higher for large stores because the supply of sites is more limited, particularly in any given local area. There are several key issues which need further analysis (and could form part of a market investigation) before one could reach a firm conclusion on barriers to entry: We suggest three:
- (a) Whether there is a pool of retail properties that could be converted to larger convenience stores, particularly in rural areas where access to and competition from other grocery retailers (supermarkets) may be limited.

- (b) How easy it would be for smaller players to expand their sites. More specifically, can stores currently below the segment that supermarkets appear to have targeted expand their operations to compete in it?
 - (c) Whether it is possible for a smaller store to compete effectively with a larger store for convenience grocery shopping.
- 3.18 Overall, the impact of supermarkets on site purchase prices may merit further consideration as part of a wider market investigation, but there are other factors (discussed in the next section) which are more clearly distorting competition in convenience retailing.

4 COMPETITION ISSUES

- 4.1 In considering whether to make a reference to the CC, the OFT has to decide whether it has reasonable grounds for suspecting that any feature, or combination of features, of a market prevents, restricts or distorts competition. This section analyses whether there are reasonable grounds for such suspicion in the case of convenience retailing.
- 4.2 We begin by considering the different types of commercial advantages that supermarkets may have, and whether or not these might give rise to competition concerns.
- 4.3 The issue of buyer power is then considered in some detail. We analyse the distortionary effect this may have on competition, its impact on consumers, and whether there are any possible remedies.
- 4.4 Finally, we consider whether continued supermarket expansion in convenience retailing may undermine the viability of independent buying groups and wholesalers, such that competitive constraints on supermarket behaviour diminish.

What commercial advantages do supermarkets have?

- 4.5 There are a range of possible commercial advantages that supermarkets may enjoy in the convenience retailing sector. These are discussed below, starting with those which would raise the least competition concerns.
- 4.6 **Superior management.** If supermarkets' expanding share of the convenience market results simply from superior management, this would not raise any competition concerns. In any event, we would expect to see examples of good and bad management among both supermarkets and other convenience retailers, without the supermarket players having a systematic advantage.¹⁷ In our view, quality of management cannot be the only factor at work.
- 4.7 **Economies of scale in supermarket operations** (excluding the purchasing terms obtained from suppliers). There may be economies of scale in retailing (e.g. in supply chain management) which place supermarkets at a competitive advantage. This is a source of efficiency and gives rise to cost savings which may benefit consumers to the extent that they passed through in retail prices. At the same time, economies of scale can represent a barrier to entry, making it harder for new players to compete and thus diminishing competitive constraints on the leading supermarkets. This is well illustrated by a quotation from the 2000 CC report:

¹⁷ In theory, it is possible that the greater scale of supermarkets might allow them to pay more to attract the best management. However, if this occurs it can be treated as an economy of scale for the purposes of competition analysis.

“Booth[s] said that economies of scale and other factors were now such that it was difficult for new retailers seeking to enter the market, and small established players such as itself, to keep pace.” (paragraph 2.135)

Hence the competition implications of scale economies are mixed. While costs may fall, there may be a reduction in competitive constraints on leading firms, with the result that not all of these cost savings are passed on to consumers.

- 4.8 **Vertical economics of scope.** This term refers to cost savings arising from the vertical integration of distribution and retailing within one company. The competition implications are similar to those for economies of scale: that is to say, costs may fall, but competitive constraints may fall with the result that not all of the cost savings are passed through into retail prices. In particular, the supply chains of supermarkets are closed to new entrants whereas those of independent buying and wholesaling groups are open, hence the ease of entry into the sector is likely to fall as independent groups are displaced by expanding supermarkets.
- 4.9 **Brand value.** Strong brands can increase barriers to entry, because consumers become less inclined to switch to new entrants. Whether or not supermarket brands are perceived as providing offsetting consumer benefits depends partly on one’s view about the role that advertising and brands play in society. Some economists have argued that brands provide benefits to consumers (e.g. by providing a signal of quality); others have argued that brand strengths are harmful to consumers (e.g. if they result from manipulative advertising).¹⁸
- 4.10 **Upstream buyer power.** Buyer power refers to the ability of large supermarkets to obtain more favourable buying terms from suppliers than would be expected under competitive conditions. In particular, a large buyer may be able to exert market power by negotiating its buying prices downwards, over and above any reduction that may be justified by any economies of scale that suppliers gain from selling in bulk to a single firm. As discussed in detail in the next chapter, our view is that buyer power has the potential to distort competition in convenience retailing and raises barriers to entry.
- 4.11 **Below-cost selling.** Europe Economics is aware of concerns of some players in the convenience sector that supermarkets may be engaging in below-cost selling when they acquire or open new convenience stores. If this were the case, it would unambiguously raise competition concerns. In the short-term consumers may gain from lower prices, but the risk is that supermarket outlets will raise prices once rivals have been driven out of business. This could happen at a local level even if supermarkets have only a low share of the convenience retailing market at a national level.

¹⁸ For a comprehensive survey of the literature on the economics of advertising, see Bagwell, Kyle (2003), “The Economic Analysis of Advertising”, March

4.12 The practice of below-cost selling in larger supermarket stores was discussed in the 2000 CC report:

“We found that all the main parties ... engaged in the practice of persistently selling some frequently purchased products below cost, and that this contributed to the situation in which the majority of their products were not fully exposed to competitive pressure and distorted competition in the supply of groceries. We took account of the fact that some consumers could benefit from being able to buy goods below cost, particularly low-income consumers, but at the same time that the practice damaged smaller reference stores and non-reference grocery outlets. This would in turn impact adversely on consumers, in particular the elderly and less mobile who tend to rely more on such stores. We conclude that the practice of persistent below-cost selling when conducted by Asda, Morrison, Safeway, Sainsbury and Tesco, ie those parties with market power, operates against the public interest.” [paragraph 1.6(a)]

4.13 The OFT would normally deal with predatory pricing under Competition Act powers (rather than through a market investigation reference). However, given that other features of the market also merit investigation, there may be grounds for examining any evidence on below-cost selling as part of a wider market investigation.

4.14 The collection of evidence on whether or not below-cost selling occurs in practice was outside the brief that Europe Economics was given by the ACS, and is not considered further in this report.

Summary of competition issues

4.15 Table 4.1 summarises the various commercial advantages that supermarkets may enjoy and their competition implications.

Table 4.1: summary of competition issues

Possible advantage	Distorts competition between existing players?	Creates barrier to entry?	Gives rise to consumer benefits?	Raises competition concerns?
Superior management	x	x	✓	x
Economies of scale	x	✓	✓	?
Vertical economies of scope	x	✓	✓	?
Brand value	?	✓	?	?
Buyer power	✓	✓	?	✓
Below-cost selling	✓	✓	?	✓

4.16 Whether or not economies of scale and scope give rise to competition concerns depends on the context. In particular:

- (a) In Chapter II cases under the Competition Act 1998, economies of scale and scope might represent a barrier to entry, and thus might help to give a firm a dominant position. However, achieving cost efficiencies through scale or scope economies¹⁹ would not represent anti-competitive conduct, and so there would be no competition concerns in the absence of evidence that dominance had actually been abused.
- (b) In assessing the acquisition of convenience store chains by leading supermarkets under the Enterprise Act 2002, it might be the case that the size of the independent buying and/or wholesaling group to which the acquired stores previously belonged will fall below the minimum efficient scale. If this is the case, the merger could lead to a substantial lessening of competition through loss of scale in the independent sector. This issue is discussed in more detail later (see section on “Independent buying groups and wholesalers”).
- (c) In a market investigation reference under the Enterprise Act 2002, economies of scale and scope could represent a feature of the market which prevents or restricts competition, particularly where they act in combination with other market features. However, any consumer benefits from the pass-through of scale and scope economies would need to be taken into consideration.

Upstream buyer power

- 4.17 With the possible exception of below-cost selling, Europe Economics is of the view that it is the buyer power of supermarkets which raises the most competition concerns. This section therefore analyses the issue of buyer power in some detail.
- 4.18 The relevant market for considering buyer power would appear to be the wholesale supply of groceries. There are significant overlaps between products sold to “top-up” shoppers in the convenience retailing market and those sold in the market for “one-stop” grocery shopping, and therefore it would seem inappropriate to regard these markets as being separate at a wholesale level.
- 4.19 It is widely accepted that the leading supermarkets are able to exercise buyer power in relation to the purchase of groceries. For example, the 2000 CC report on supermarkets stated that:²⁰

“... we believe that any main party with more than an 8 per cent share of grocery purchases for resale from its stores, and accordingly all the major buyers (Asda, Safeway, Sainsbury, Somerfield and Tesco), are, for the most part, able to control their relationships with suppliers to their own advantage, whilst the smaller multiples are not able to do so to anywhere near the same extent.” (paragraph 2.458)

¹⁹ We are defining economies of scale as excluding the exercise of buyer power.

²⁰ *Supermarkets*, CC, October 2000, Cm 4842

- 4.20 The CC report analysed differences in prices paid by eleven grocery retailers for suppliers' top five lines. Tesco was found to pay the lowest prices; Budgens was found to pay 11% more on average.
- 4.21 The results of a supplier questionnaire discussed in the 2003 Safeway report²¹ suggest that supermarkets have increased their buying power through time:

“Although responses varied widely, the balance of the responses was that suppliers’ negotiating strength with each of the main parties [Asda, Morrison, Sainsbury and Tesco] had weakened over the last four years, especially against Asda and Tesco.” (paragraph 6.76)

Evidence from phone discussions

- 4.22 Europe Economics held a number of phone conversations with players in the convenience store sector, in which buying terms were one of the key issues for discussion.
- 4.23 We were informed that basic purchase prices can often be complicated by other pricing elements, such as over-riders and advertising support. Supermarkets were felt to have a particular advantage in winning advertising support, because they were better placed to assure suppliers that they would honour commitments made (e.g. in relation to the positioning of products within stores or the final retail price). Wholesalers supplying independently-owned stores were less well-placed to make such agreements.
- 4.24 There was general agreement that supermarkets obtained better buying prices, at least on some products. One contact suggested that the largest supermarket obtained buying prices which were 10 per cent lower on average than for the majority of the convenience sector.
- 4.25 One contact emphasised the different type of trading relationship that suppliers have with large supermarkets compared to other buyers. In particular, the contact stressed that large supermarkets had substantial power over suppliers because they could threaten to de-list products and thus foreclose a large part of the grocery market to the supplier. The contact felt that if an independent buying group were to threaten to de-list products, it would not have the same effect due to the smaller share of the grocery market to which suppliers would lose access.
- 4.26 There was a general view that the disparity in buying terms between leading supermarkets and other players varied depending on the product in question. For example, we were told that independent stores obtained comparable terms for

²¹ *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc, CC, October 2003, paragraph 1.8.*

newspapers. However, supermarkets were felt to enjoy a significant buying advantage in core grocery products.

- 4.27 We were informed that some of the largest suppliers published transparent pricing information, setting out exactly what pricing discount was being offered for different volumes. This was felt to be helpful to the independent sector in understanding the state of play. We were also informed that other suppliers were much less transparent, and that in many cases independent sector buyers did not know how their buying prices compared to those obtained by leading supermarkets.
- 4.28 There was some support for the idea that supermarkets should be forced to publish their buying terms to increase transparency and to improve the bargaining position of the independent sector when negotiating with suppliers. This possible remedy is discussed in more detail later in this section.

Distortion to competition

- 4.29 The question arises: are there reasonable grounds for suspecting that the buyer power of supermarkets can prevent, restrict or distort competition in convenience grocery retailing?
- 4.30 An answer is provided by an OFT research paper by Dobson *et al* on buyer power.²² This paper explicitly recognised the distortions to retail competition that may result from unequal buying power at the wholesale level:²³

“... buyer power is likely to be unequal among buyers (eg: due to firm-size differences), in which case its exercise may exacerbate differences in downstream competitive positions, consequently **distorting competition** (eg: leading to the withdrawal of smaller firms).” (p.6)

“... buyer power can potentially undermine both upstream competition between suppliers and **distort downstream competition** when it serves to exaggerate differences in competitive positions.” (p.37)

- 4.31 Section 7 of the paper discusses in some detail the nature of this distortion to competition. The relevant quotation is given in full because of its pertinence to the case of supermarkets competing for convenience grocery retailing.²⁴

“... when power is asymmetrically distributed between buyers, say due to firm size or order size differences, then there are concerns that those with greater bargaining power will be able to negotiate substantial discounts from suppliers compared to other less significant buyers. This may in turn **distort the nature of downstream (retail)**

²² Paul Dobson, Mike Waterson and A Chu, “The Welfare Consequences of Buyer Power”, OFT Research Paper 16, 1998

²³ In all of the quotes in this section, the emphasis in bold has been added by Europe Economics.

²⁴ Paragraph breaks have been added to this quotation to aid clarity.

competition, where the lower costs for key buyers translates into competitive advantage over other firms when they act as sellers.

In the context of retailing, for example, a dominant firm may be able to negotiate substantial discounts on wholesale prices and then use these lower prices as a basis for exercising selling power in the retail market, where it might seek to reduce competition by acting in a predatory manner, forcing smaller retailers to withdraw from the market, allowing it to gain market share, which serves to reinforce its bargaining power and competitive advantage over other retailers. For the dominant retailer, this can represent a virtuous circle where a cost advantage can be used to increase its market share advantage which can in turn be used to gain an even larger cost advantage over rivals, etc. But for suppliers and other retailers they are equivalently caught in a vicious circle. For suppliers, once they give discounts to a dominant buyer then this is only likely to yield the buyer a greater competitive advantage in its downstream market which in turn will increase its bargaining power forcing suppliers to give even greater discounts. For the other retailers, they face the problem of a declining competitive position, being unable to negotiate the same discounts as the dominant firm, with their profitability consequently suffering and their long-term viability undermined.

The overall effect of this process on consumers is not certain, but they may ultimately lose out through reduced choice of retailers as well as increased prices if the dominant retailer is able eventually to set higher prices without the prospect of weakening its stranglehold on the market.” (p.28)

- 4.32 The OFT research notes that these concerns about buyer power may particularly arise in relation to retailing:

“... most recent attention in regard to buyer power has focused on that in the context of retailing, not least since it is this sector which has seen such rapid consolidation (especially relative to corresponding consolidation at the supplier level) and where evidence has emerged of a shift from supplier domination to buyer domination in the supply chain. It is also the case that in this sector there is wide scope for a variety of buyer-induced practices, which may be potentially anticompetitive, and more general concern that the exercise of buyer power may not only distort competition at the supplier level, but also at the downstream level **where retail competition itself may be restricted and distorted.**” (p.33)

- 4.33 The effects of distorted retail competition can be illustrated by considering the following hypothetical examples:

- (a) Suppose a particular independent store is run very efficiently (e.g. it has effective cost control measures or is efficient at managing waste) and hence has lower costs than the local supermarket-owned convenience store. In a competitive market, consumers would choose to shop at the independent store; however, because of the distortion caused by unequal buying power, the more efficient store goes out of business.
- (b) If an independent store is in a better location for local consumers than the rival supermarket-owned convenience store, then in a competitive market it would attract

more trade. However, because of unequal buying power, prices are distorted and consumers shop at the less conveniently located store.

- (c) Suppose an independent store is highly innovative and offers consumers a range of attractive services alongside a basic range of groceries. Consumers value this offering and in a competitive market would choose to shop at the independent store. However, competition is distorted by the unequal buying power enjoyed by rival supermarket-owned stores, and the innovative independent store goes out of business.

4.34 In summary, the OFT's research strongly suggests the exercise of upstream buyer power by supermarkets has the potential to distort competition in the downstream market for convenience retailing – thus meeting the criteria for the OFT to refer the convenience market to the CC.

Consumer detriment

4.35 Consumers may lose out in the long run from a reduction in competition if upstream buyer power allows a few firms to establish market power in the downstream market. Once firms have established a dominant position, they may be in a position to:

- (a) raise prices above competitive levels to increase profitability;
- (b) cut back on the range of products on offer or the number of retail outlets, thus increasing profitability at the expense of reduced consumer choice.

4.36 The following question arises, however: do consumers lose or gain in the short run from the exercise of buyer power? Is there any truth in the suggestion that consumers benefit if supermarkets achieve better buying terms from their suppliers and pass these savings on through lower retail prices?

4.37 The answer depends partly on the nature of competition between suppliers of groceries (which may differ from one grocery product to another):

- (a) In cases where the market for the supply of a particular grocery product is monopolistic or oligopolistic, supermarket buyer power may have the beneficial effect of reducing the ability of upstream producers to exploit market power (an effect generally referred to as “countervailing buyer power”);
- (b) For grocery products where the supply side of the market is competitive (including markets in which there is “monopolistic competition” between suppliers of differentiated products), it seems unlikely that consumers overall will benefit from supermarket buyer power, for reasons which we explain below.

Impact of buyer power if supply-side of market is competitive

- 4.38 Economic theory suggests that in competitive markets not distorted by market failures, market outcomes will converge towards a socially-optimal “competitive equilibrium”. This equilibrium will have a number of favourable characteristics, including:
- (a) Production taking place at lowest cost;
 - (b) Prices reflecting costs, with suppliers making a normal level of profit but no more;
 - (c) Decisions about what is produced and in what quantities reflecting consumers’ preferences.
- 4.39 Economic theory also suggests that the existence of market failures – of which market power is an example – can distort markets and move them away from the optimal outcome.
- 4.40 Buyer power is simply a type of market power, and we would therefore expect the exercise of supermarket buyer power in product markets which would otherwise have been competitive to give rise to detrimental effects.
- 4.41 The impact of buyer power can be analysed by remembering that in its absence suppliers in a competitive market would be making a normal level of profit (but no more). Therefore, if supermarkets reduce their buying prices through the exercise of buyer power, suppliers will no longer be making sufficient profit to justify remaining in the market. This would not be a sustainable situation, and we would expect to see market adjustments until suppliers were again making a normal level of profit. At least two types of market adjustment are possible, both of which would harm the interests of consumers:
- (a) *Reduction in choice and innovation.* In order to supply to supermarkets at the prices they demand, suppliers may cut back on investment in new products and in innovation more generally.
 - (b) *Exit of suppliers leading to increased prices for non-supermarket buyers.* Suppliers who are no longer making sufficient profit may choose to leave the market. This reduction in supply will increase prices for non-supermarket buyers (who are unable to hold prices down by exercising market power). The process will continue until prices to non-supermarket buyers have risen sufficiently to offset the lower revenues that suppliers now earn from supermarkets and thus to restore supplier profitability. The net result is that supermarkets achieve lower prices at the expense of other buyers paying higher prices – an outcome known as the “waterbed effect.”
- 4.42 In the 2003 Safeway report, the CC recognised these two potential effects:
- “The consequences of uncompetitive prices [resulting from buyer power] may include ‘waterbed’ effects (where suppliers seek to recoup the lower prices they receive from large retailers through higher prices to smaller grocery retailers) or a further general

weakening of some suppliers' bargaining positions, with the result that some grocery manufacturers are likely to find investment in new products or innovative manufacturing techniques more difficult or no longer possible." (paragraph 1.20)

- 4.43 However, in our view the "waterbed effect" does **not** require suppliers to react in a conscious way to supermarket buying power by raising prices to non-supermarket buyers to recover lost profits. Considered on its own, this would imply that suppliers had market power (necessary in order to raise prices) and that they were not previously acting in a profit-maximising way in setting prices for non-supermarket buyers – which would be dubious assertions. Rather, Europe Economics suggests that the "waterbed effect" occurs through the dynamics of entry and exit in an (otherwise) competitive market distorted by buyer power.²⁵
- 4.44 The 2003 Safeway report concluded that while there was little evidence of an immediate or short-term waterbed effect, this was not the case in the longer term:
- "From the evidence available to us, we take the view that there may be some water-bed effect for some classes of suppliers, especially over the longer term." (paragraph 2.248)
- 4.45 This would be consistent with the view that the waterbed effect occurs through entry and exit in the longer term, rather than through the conscious behaviour of suppliers in the immediate aftermath of price reductions imposed by supermarkets.

Implications of "waterbed effect" for consumers

- 4.46 Clearly, customers shopping at supermarkets gain to the extent that supermarkets pass through their better buying terms into lower retail prices. On the other hand, customers shopping at other grocery stores will lose out through higher retail prices. *On the assumption that supermarkets pass through 100 per cent of their buying discount* then overall these two effects cancel out. While there will be distributional effects, consumers as a whole are neither better nor worse off.
- 4.47 However, do supermarkets pass through 100 per cent of the savings from their better buying price? Large supermarkets buying on significantly better terms than other players would be able to set retail prices at a level which undercuts other retailers while still retaining some of the savings from lower buying prices in the form of higher profits. Alternatively, better buying prices might partly be used to offset inefficiency in other areas. In either case, it seems conceivable that at least part of the saving would not be passed through.

²⁵ If the market for a particular grocery product is expanding, the "waterbed effect" could occur through a reduction in the level of entry rather than through the exit of existing firms.

- 4.48 If supermarkets keep back some of the savings from better buying prices, the result is startling. Once the waterbed effect is taken into account, consumers as a whole may actually pay more. This happens because:
- (a) customers in other grocery stores pay higher prices sufficient to offset the supermarkets' better buying terms; but
 - (b) customers shopping at supermarkets gain by a lesser amount because supermarkets channel some of the savings from their better buying terms into higher profits (or use better buying prices to offset inefficiency in other areas).

Illustrative calculations of waterbed effects

- 4.49 Europe Economics has carried out some illustrative calculations to show the potential size of this consumer detriment under certain speculative assumptions. The calculations are based on a stylised version of reality, in which the four largest supermarkets have equal buying power and all other stores have none. (In practice, buying power is likely to vary according to the size of the grocery retailer.)
- 4.50 The input assumptions used by Europe Economics are shown in Table 4.2. The two most important assumptions relate to:
- (a) The proportion of grocery sales for which the waterbed effect occurs. As discussed above, we suggest that a long-term waterbed effect is most likely where the supply-side of the market is competitive or monopolistically competitive, and least likely where the supply-side of the market is oligopolistic. We have used a speculative figure of 90 per cent for the proportion of groceries falling into the first category.
 - (b) The proportion of their lower buying price which supermarkets pass through to their customers. As discussed above, there seems no reason to believe *a priori* that all of the saving from lower buying prices will accrue to consumers. Therefore, we have used a speculative figure of 50 per cent for the proportion passed through.²⁶
- 4.51 The calculations assume that supermarkets extract the same discount in buying prices for all groceries, regardless of the supply side of the market. This could be a conservative assumption – supermarkets may be able to extract a larger discount where the supply side of the market is competitive (which is also where buyer power most damages consumer interests) than is possible in negotiations with oligopolistic suppliers.

²⁶ This is 50% of the reduction in buying price compared to the counterfactual of no buyer power. For grocery products for which a waterbed effect occurs, this equates to a lower proportion of the final discount in buying price *relative to other buyers*.

Table 4.2: Inputs used in calculations

Code	Parameter of calculations	Value	Notes
Downstream market			
A	Sales by biggest four supermarkets (£bn)	56	Europe Economics figure calculated by scaling up TNS data for 12 weeks to 24 April 2005
Breakdown of grocery wholesale market			
B	Oligopoly (no waterbed effect)	10%	Speculative assumption
C	Competition or monopolistic competition (long-term waterbed effect)	90%	= 100% – D
Other parameters			
D	Wholesale price as proportion of retail price	75%	Equates to a figure of 25% for gross margin
E	Assumed buying price discount of four largest supermarkets	6%	Relative to counterfactual of no buyer power. (For goods with waterbed effect, the final buying discount <i>relative to other buyers</i> will be higher). We made no attempt made to model differences in buyer power between the largest supermarkets; nor to take account of variations in buying power for different types of product.
F	Proportion of discount passed through to consumers	50%	Speculative assumption

4.52 Table 4.3 sets out Europe Economics' calculations of consumer detriment. For the sake of transparency, we have included notes which use code letters to describe precisely what calculation was undertaken at each stage. The basic approach is to compare:

- (a) The gains made by supermarket customers from buyer power – both for products with oligopolistic supply and for products with competitive supply;
- (b) The loss suffered by consumers in other stores due to the long term waterbed effect for products with competitive supply.

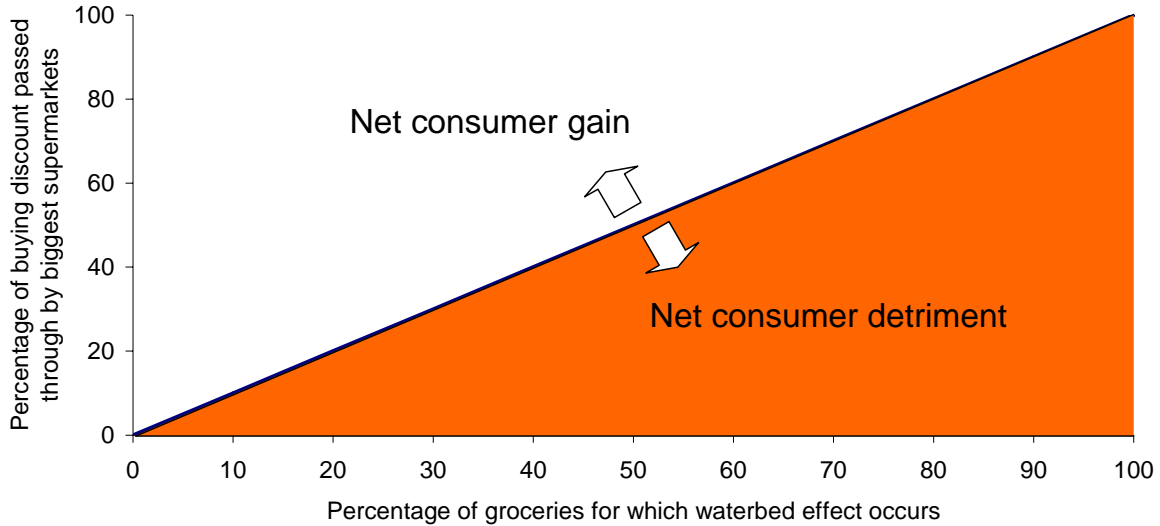
Table 4.3: calculations of net consumer detriment

Code	Step of calculation	Amount (£bn)	Notes
Supply side - oligopoly			
G	Purchases by largest 4 supermarkets (before discount)	4.20	= A x B x D
H	Buying discount of largest 4 supermarkets	0.25	= G x E
I	Amount passed through to supermarket customers	0.13	= H x F
Supply side - competition or monopolistic competition			
J	Purchases by largest 4 supermarkets (before discount)	37.79	= A x C x D
K	Buying discount of largest 4 supermarkets	2.27	= J x E
L	Amount passed through to supermarket customers	1.13	= L x F
M	Additional amount paid by consumers in other stores due to waterbed effect	2.27	= K
N	Net gain (loss) to consumers	(1.13)	= L – M
All groceries			
O	Net gain (loss) to consumers	(1.01)	= I + N

- 4.53 The results show that under these speculative assumptions, consumers could end up paying £1 billion more every year for their groceries as a result of supermarket buyer power. Over a period of 10 years this would give a total (discounted) consumer detriment of £8 billion.²⁷
- 4.54 This figure is very sensitive to the assumptions used for the proportion of groceries for which there is a waterbed effect and the proportion of supermarkets' buying discount which is passed through to customers. This is illustrated in Figure 4.1, which shows the combinations of values for these parameters which yield a net consumer detriment.

²⁷ Discounted at the social discount rate of 3.5% recommended in HM Treasury (2003), "The Green Book: Appraisal and Evaluation in Central Government".

Figure 4.1: impact of assumptions on net consumer detriment



Note: The y-axis shows the percentage of the reduction in buying price – compared to the counterfactual of no buyer power – which is passed through to consumers. As noted earlier, for grocery products for which a waterbed effect occurs, this equates to a lower proportion of the final discount in buying price relative to other buyers.

- 4.55 Further analysis is required to determine which values for these parameters best represent reality, and hence whether there is a net consumer detriment or surplus and of what size.
- 4.56 Estimating these parameters may not be easy. For instance, it might be tempting to think that the extent of pass-through to supermarket customers can be estimated by looking at whether supermarket retail prices are as low relative to other grocery stores as would be expected given supermarkets' better buying terms. However, such a comparison is likely to be distorted by other cost differences. For example, supermarkets might charge lower prices due to economies of scale while at the same time holding back a high proportion of the savings from their buying discount.
- 4.57 The overall message from these illustrative calculations is that the possibility of a substantial consumer detriment – of perhaps £1 billion per year – cannot be ruled out, but that further investigation is needed to come to a definitive conclusion. Detailed analysis on this issue could usefully be conducted as part of a market investigation by the CC.

Possible remedies

- 4.58 The above analysis naturally leads to the following question: even if supermarket buyer power distorts competition and harms consumers, can anything be done to remedy the problem?
- 4.59 In our view, there are a range of possible remedies which could be considered as part of a CC investigation, such as:

- (a) Increasing the transparency of buying prices;
 - (b) Introducing safeguards into the Supermarkets Code of Practice to protect suppliers from arbitrary de-listing of products by supermarkets;
 - (c) Mandating equal buying terms.
- 4.60 We have limited our analysis of possible remedies to a brief consideration of the first of these, which (as mentioned in paragraph 4.27) received support from some industry contacts to whom we spoke.
- 4.61 There are at least two ways in which buying prices could be made more transparent:
- (a) Suppliers could be required to publish their prices, making explicit what volume discounts they were willing to offer, and to sell only at their published prices (i.e. without offering behind-the-scene discounts).
 - (b) The largest supermarkets could be obliged to publish their buying terms for each product, separately identifying each of the various pricing elements (basic purchase price, over-riders, promotional discounts etc).
- 4.62 The latter option would appear to be preferable, for a number of reasons. First, the obligation would rest on a small number of parties, thus significantly reducing compliance problems. Second, these parties would be the supermarkets that have buyer power – arguably a more appealing solution in terms of natural justice than placing an obligation on suppliers. Third, the obligation could be introduced by making suitable amendments to the existing Supermarket Code of Practice.
- 4.63 Clearly, this remedy would involve the publication of a large volume of pricing information, given the number of products stocked by supermarkets. However, it seems reasonable to expect that supermarkets would have such commercial information readily available. Furthermore, there seems no reason why modern IT would not allow such information to be released into the public domain in database form (e.g. over the internet).
- 4.64 What effect would increased transparency have, given that it would not actually prohibit suppliers from offering lower prices to large supermarkets than to other buyers? The answer is that inequalities in buyer power are likely to fall, although by how much is not clear. The reasons for this include:
- (a) The position of independent buying groups would be strengthened in negotiations with suppliers, because they would be able to prove (where this is the case) that suppliers were charging lower prices to supermarkets.
 - (b) The buying power of supermarkets would diminish in negotiations with their suppliers. In particular, suppliers might argue that they could not afford to give further discounts to supermarkets, because the new price would be published and they would come under pressure to supply on the same terms to other parties.

- 4.65 Of course, there are potential drawbacks as well. For example, the CC would want to think very carefully about the impact on competition between suppliers of competing grocery products.
- 4.66 Overall, increasing the transparency of buying terms provides an example of a possible remedy which merits serious consideration and which might be considered as part of a CC investigation.

Conclusion on buyer power

- 4.67 The buyer power of supermarkets already distorts competition and creates a barrier to entry in the grocery sector, and may give rise to detrimental effects on consumers.
- 4.68 The expansion of supermarkets into the convenience store sector is likely to exacerbate the problem, for two reasons:
- (a) A greater proportion of grocery sales will be subject to distorted competition;
 - (b) As supermarkets increase their share of grocery sales their buyer power is likely to increase further.

Independent buying groups and wholesalers

- 4.69 Some in the industry have voiced concern that the acquisition of convenience stores by supermarkets may undermine the viability of the buying groups and wholesalers serving other remaining convenience stores. This might happen because these groups will lose members and hence scale advantages. If this is the case, then continued expansion by the supermarkets will have the effect of further weakening the competitive constraints on supermarket behaviour in the convenience retailing sector. IGD has stated that:

“For many years, convenience retailers have sought to overcome the limitations of fragmented store ownership through the development of various organisations, all intended to deliver benefits for members through buying, the support services or political influence.

With large numbers of convenience stores changing ownership, the influence of the organisations can be undermined, to the detriment of those remaining in membership.”²⁸

- 4.70 This reduction in viability might happen in at least two ways:
- (a) Buying groups and wholesalers may lose bargaining power with suppliers, further widening the gap between the buying prices obtained by leading supermarkets and those obtained by others in the sector;

²⁸ IGD (2004), *Consolidation in convenience retailing: examining the implications*, December, p.151

(b) Buying groups and wholesalers may lose economies of scale. It seems likely that at least some of the costs of running a wholesaling operation may be fixed (e.g. certain head office and warehouse costs), even in the long run.²⁹ As these groups lose scale, such fixed costs will have to be recovered over smaller volumes with the result that prices charged in the independent sector will tend to rise.

4.71 At least in theory, these effects could create a “vicious circle” in which loss of volume to supermarkets raises prices in the independent sector, in turn leading to price increases and further loss of volume. Thus could lead to an accelerating decline of the independent sector along with a reduction in its ability to exert a competitive constraint on supermarkets in the convenience retailing sector.

Speculative calculations

4.72 Europe Economics has carried out some illustrative calculations of how these effects might work. The assumptions are mostly speculative – the purpose is simply to illustrate the concepts and highlight the need for more rigorous analysis by competition authorities.

4.73 Input assumptions are shown below, for a hypothetical wholesaling group with initial volumes (at retail prices) of £2 billion. The key assumptions relate to the breakdown of costs between fixed and variable components. All of the purchase costs of groceries (assumed to be 75 per cent of the retail price) are treated as variable, and in the absence of any firm evidence Europe Economics used a speculative figure of 30 per cent for the proportion of other wholesaling and retailing costs which are fixed in the long run.

²⁹ One contact volunteered to provide detailed cost information to allow the breakdown of fixed and variable costs to be estimated. We were not able to take up this offer due to the limited time left before the OFT’s deadline, but this type of analysis might usefully be pursued by the competition authorities.

Table 4.5: input assumptions (some of which are speculative)

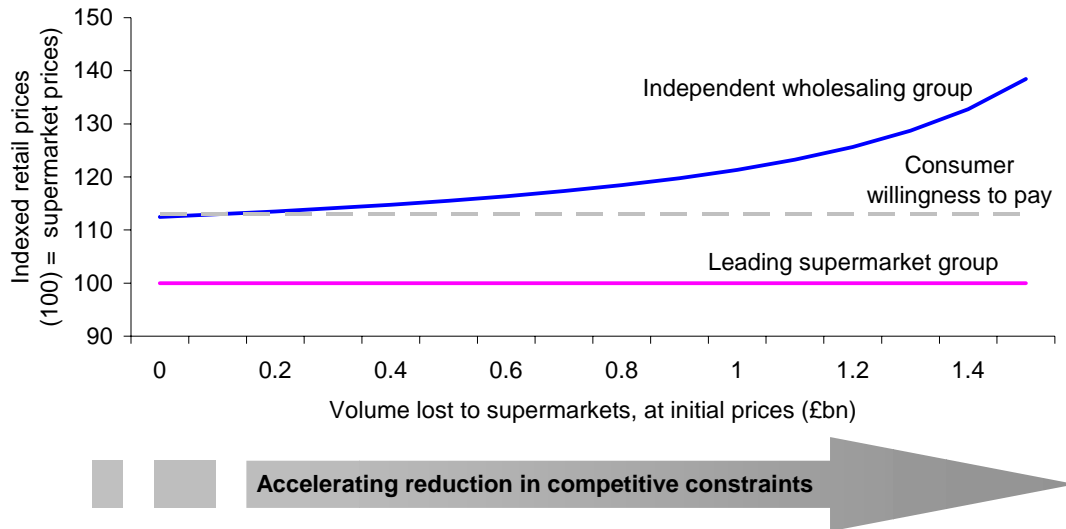
Parameter	Assumed value	Comments
Initial size of wholesaling group (£bn)	2	Hypothetical example
Initial price premium over supermarkets (%)	12.5	IGD quotes typical figure of 10-15%
Initial breakdown of grocery retail prices (%)		
Purchase cost of grocery supplies	75	In line with figures for gross margin quoted in phone conversation
Wholesale and retailing costs (including normal profit)	25	
Change in buying prices per £1bn of buying volume (%)	0.5	The figure of 0.3% has been quoted to us for supermarkets; some contacts have suggested 0.5% for smaller groups (note 1)
Initial breakdown of wholesale and retailing costs (%)		
Fixed costs	30	Speculative figures
Variable costs	70	

Note 1: It has also been suggested that it is harder to gain an improvement in buyer power as scale increases than it is to lose buyer power as scale falls.

- 4.74 Figure 4.2 shows how the total costs, and hence retail prices, for stores served by the independent wholesaling group might change as sales volumes are lost to the supermarkets. (In fact, it makes no difference to the analysis whether this occurs through supermarket acquisitions or through a more general loss of convenience shopping to supermarket-owned stores.)
- 4.75 Market research based on shopper interviews has found that shoppers are willing to pay a premium of 13% over supermarket prices in convenience stores, and this is also shown on the graph.³⁰
- 4.76 The results suggest that – under the speculative assumptions used – independent retailers served by the wholesaling group will pose an increasingly weak constraint on supermarket behaviour in convenience retailing as the wholesaling group loses sales and hence scale. This is particularly likely once prices in independent stores have increased beyond the level that consumers are willing to pay.

³⁰ Convenience Tracking Programme (CTP), him! 2004.

Figure 4.2: speculative calculations showing potential weakening of competitive constraints on supermarkets



4.77 The key driver of this result is loss of scale economies. This in turn is highly dependent on the proportion of costs which are assumed to be fixed, highlighting the need for further evidence to be gathered in this area.

4.78 The reduction in bargaining power with suppliers has a much smaller effect. Intuitively this seems reasonable, since independent groups are likely to have limited bargaining power to begin with, relative to that enjoyed by supermarkets.

Scope for consolidation

4.79 A further area where Europe Economics believes more analysis is needed is the extent to which the non-supermarket convenience sector could consolidate to offset any loss of scale resulting from supermarket expansion.

4.80 Currently, there are a number of separate buying groups and wholesalers. In theory, consolidation among these parties could restore scale economies following the loss of volume to supermarkets, in which case the impacts shown in Figure 4.2 may not occur. (The existing distortion caused by the buying power of supermarkets would still remain.³¹)

4.81 In considering this issue, the competition authorities might investigate:

³¹ IGD has stated that “even if the buying power of all UK convenience retailers could be harnessed, they would remain at a disadvantage [relative to Tesco]”. This level of consolidation seems unlikely, and would probably be undesirable on competition grounds; but even if it happened, it would not give non-affiliated convenience stores the same buying power as the largest supermarket.

- (a) Whether there are any economic factors which might prevent such consolidation (for example, are there economic reasons why different business models might be appropriate for different types of store?)
- (b) Whether consolidation (beyond a certain point) among non-supermarket players might in itself have undesirable consequences for competition. For example:
 - There may be a reduction in the extent to which symbol groups compete to provide services to independently-owned stores, leading to a reduction in innovation;
 - In a highly consolidated convenience retailing sector, large non-supermarket players may have less incentive to compete vigorously with supermarkets on price.

Conclusion on independent buying groups and wholesalers

4.82 Although in Europe Economics' view the main concern is the distortion caused by supermarket's existing buyer power, the firm recommends that a CC investigation should also look at whether the continued expansion of supermarkets in the convenience retailing sector reduces the viability of other players such that competitive constraints on supermarkets are likely to weaken.

5 CONCLUSION

- 5.1 Europe Economics is of the view that it is the buyer power of supermarkets which raises the most competition concerns. The relevant market for considering buyer power appears to us to be the wholesale supply of groceries. It is already widely accepted (by the CC and others) that the leading supermarkets are able to exercise buyer power in relation to the purchase of groceries. The question is whether, in the market for convenience retailing, there are reasonable grounds for suspecting that any feature, or combination of features, prevents, restricts or distorts competition. The OFT's own research strongly suggests the exercise of upstream buyer power by supermarkets has the potential to distort competition in the downstream market for convenience retailing – thus meeting the criteria for the OFT to refer the convenience market to the CC.
- 5.2 We have concluded that the buyer power of supermarkets already distorts competition in convenience retailing. The further expansion of supermarkets into the convenience store sector is likely to exacerbate the problem, because a greater proportion of grocery sales will be subject to distorted competition, and, as supermarkets increase their share of grocery sales, their relative buyer power is likely to increase further.
- 5.3 We have also concluded that the exercise of buyer power by supermarkets may lead to consumer detriment through the so-called “waterbed effect”, whereby lower buying prices to supermarkets come at the expense of higher buying prices to other parties. Where the supply-side of the grocery market is competitive, this may occur through the exit of suppliers rendered unprofitable by supermarket buyer power, enabling remaining suppliers to increase prices to non-supermarket buyers.
- 5.4 We are aware of concerns that competition in the convenience market may also be distorted by below cost selling. However, as we have already noted, ACS is dealing with this topic by way of its own separate submission to the OFT.
- 5.5 Although we have heard anecdotal evidence that supermarkets' acquisition intentions in the convenience store sector have raised site prices, we have not been able to verify this independently, or to establish the extent to which prices might have been affected.
- 5.6 In Europe Economics' view the main concern is the distortion to competition caused by supermarkets' existing buyer power. Our conclusion is that that a market investigation is called for on this ground alone.
- 5.7 Such an investigation should also look at:
- (a) whether the entry of supermarkets into the convenience store sector reduces the viability of non-affiliated players and distribution networks such that competitive constraints on supermarkets are likely to weaken further; and
 - (b) whether supermarket acquisitions are creating barriers to expansion by existing convenience store operators or barriers to entry by potential competitors.

APPENDIX 1: SYMBOL GROUP OPERATION: THE OFFER OF P&H

Background

In 1998 Palmer & Harvey McLane Ltd introduced a dedicated team of retail specialists to assist their independent customers to develop the retail potential of their business through the Supershop and Your Store Symbol concepts. The acquisition of the Mace symbol group two years later offered a highly respected fascia in the established convenience sector, and with the introduction of the highly successful Mace Express format P&H now offers a professional retail solution for every market sector. From the impulse based CTN, across the emerging convenience sector and forecourts to the full blown convenience store, P&H have a retail support package that can develop sales, improve profitability, and bring the increased professionalism in today's highly competitive market.

Introduction

Take a look at your competition. What makes the multiple operators in both the convenience and forecourt sectors successful? You would agree it's professionalism, investment, retailing discipline, product group management and marketing. With P&H Symbol you will keep your independence but will be part of a group that really can develop your business for the challenges that lie ahead.

Professional retail solutions

P&H now offers you a professional retail solution for every market sector. From the impulse based CTN, across the emerging convenience sector and forecourts to the full blown convenience store, P&H have a retail support package that can develop sales, improve profitability, and bring increased professionalism in today's highly competitive market.



Supershop

The Supershop development package is especially designed for impulse CTN. Maximising the core retailing strengths whilst adopting merchandising and promotional techniques that will drive the impulse potential that exists.

Current membership: 270
Membership fee: £20 per week
Minimum weekly turnover: circa £5,000

Your Store

In the main confined to Scotland and N Ireland, the Your Store symbol group has a dedicated support package that encompasses the market sectors of both Mace and Mace Express in these regions.

Current membership: 135
Membership fee: £35 per week
Minimum weekly turnover: circa £8,000

Mace Express

Designed to develop retail business within the CTN or forecourt diversifying into limited convenience retailing - but backed with the full support of the parent brand, Mace.



Current membership: 100
Membership fee: £35 per week
Minimum weekly turnover: circa £8,000

Mace

The complete support package for the 'full blown' convenience store operator. Everything the retailer needs to maximise the potential business development of the store.



Current membership: 245
Membership fee: £35 per week
Minimum weekly turnover: circa £10,000

A retail partnership

P&H Symbol is all about a working partnership with the professional retailer who is dedicated to maximise their outlets potential, increase its profitability and ensure a viable and sustainable business.



Retailer support

With P&H Symbol the retailer retains his/her independence and identity but benefits from a dedicated Symbol Manager that is with the retailer every step of the way, lending practical support including:

- Initial presentation of benefits and costs
- Site survey - *analysis of trading history / trading patterns / ranges*
- Demographic survey - *to establish strengths, weaknesses and opportunities*
- Cluster Solution - *CICA socio demographic info. determining category strengths*
- Trading profile - *Category space versus turnover and profitability analysis*
- Range recommendations
- Business proposals
- Sales projections
- Refurbishment proposals

- Return on Capital Investment summary
- Scale drawings
- Access to preferred shopfitter
- Contract management of project
- Liaison with third party suppliers
- Assistance with off licence application
- Stock and planogram requirements
- Merchandising
- Completion of small projects using existing equipment
- Imagery installation
- Opening 'fun day'
- Ongoing business development meetings
- Access to the P&H finance schemes preferential rates

Understanding your business

Before recommending any changes or investment we will analyse your business and identify the opportunities that exist. The P&H symbol management team will prepare proposals and by working together we can help maximise the potential of your business. It could be as simple as a change to your store layout, or a complete refurbishment with EPoS, we have the solutions. Access to funding could be available via the P&H finance package.



The cost effective entry into symbol retailing

P&H Symbol offers retailers an extremely cost effective entry into symbol retailing, providing the following benefits:

- Enhanced purchasing terms from P&H and its subsidiary companies
- A competitive discount structures across all product categories
- A 3 weekly exclusive symbol promotional programme including excellent consumer offers from top brand leaders
- Full colour point of sale material
- Free consumer leaflets

Appendix 1: Symbol Group Operation: the Offer of P&H

- Exclusive loyalty bonus schemes for disciplined retailing - 'the more you buy the more you earn'
- A complete range of category 'blueprints' and planograms installed and maintained to ensure the retailer stocks the right products and maintains retailing discipline
- An exclusive symbol 'Retailer Reward Scheme' that can earn the retailer up to an extra 2.5% annual retrospective discount paid on the total of the participating manufacturers purchases via P&H and its subsidiary companies
- Free entry into the symbol annual holiday incentive scheme where the winners are taken on an all exclusive 5 star package to Cyprus
- YP SPRINT EPoS finance package which couples preferential leasing rates with an annual cash back bonus worth up to £5,000 over 5 years, means that EPoS has never been more affordable.
- Exclusive quarterly ORD from ACE, the P&H third party drop shipment scheme
- Dedicated retailer support teams
- Retail business advisors
- Access to Mace own label products
- Mace work-wear and branded goods

All designed to develop retail sales and increase profitability.

Training is the key to professionalism

Every P&H symbol retailer has access to a 'Trading Standards and Operations Manual', an essential tool to understanding - store operations, business development, personnel and employment legislation. It also contains staff training guides and checklist.

NVQ training is provided via 'protocal' learning.' Introduced in November 2000 over 206 candidates from 82 stores were enrolled by January 2001, and a further 172 stores had registered their interest.

Group training is provided at regional level by the P&H external training department.



The future of symbol

As the strength of the convenience sector confidence continues to grow, more and more of our retailers are investing in their business, but they demand the best whilst wanting value for

their money. For this reason P&H have launched Mace Express "Vision".

A concept store that utilises up to the minute materials, finishes, design features and merchandising techniques.

The Mace blue and style of logo will be retained but set on fascia that is manufactured in a brushed aluminium finish. This "silver" theme is continued throughout the store interior and complimented by the blue on the counter and pelmet detail. The refrigeration equipment will also follow this silver and blue theme.

The wooden floor softens the theme of a complete 'turn key' refurbishment package that will have huge aesthetic appeal for the consumer. All backed by the latest technology and retailing techniques. With constant attention to business development through increased professionalism and high standards.

From the professional CTN retailer right through to the latest design innovation of Mace, P&H has a turn-key package designed to bring the Retail Solutions for the 21st century.

[end]

APPENDIX 2: PROPERTY PRICES

- A1.1 There have been over 30 mergers or acquisitions in the convenience store sector in the past three years. However, for some of the transactions the precise terms such as the price paid to acquire the shares and the level of net debt have not been revealed.
- A1.2 This has meant that the statistics we were able to construct were based on a limited data set. A further complication arises when averages are weighted (for instance by the number of stores) because the Tesco-T&S acquisition is significantly bigger than the others (larger than all others combined for the full 16 transaction data set, with the Co-op-Alldays transaction accounting for over a quarter of the stores considered).
- A1.3 Convenience store operators are not a homogenous group, with many transactions involving franchise operators or leased property rather than freehold. Price may also be affected by the different size and variety of stores (including, for example, CTNs) and the presence of head office or distribution infrastructure that are acquired together. The figures we obtained were adjusted for some of these problems by leaving out transactions that mainly contained CTNs and symbol groups, such as the Londis and Dillons acquisitions.
- A1.4 The following tables summarise the results of our analysis of site prices for two different price indicators (ratio of purchase price to annual profit, and price per store). Some of the original data has been reproduced in table 2.5.

Table A2.1: statistics on ratio of purchase price to annual profit

(6 transactions)	Ratio of purchase price to annual profit	
Lowest	11.3	Tesco-T&S
Highest	25.6	Tesco-Adminstore
Average	19.8	
Weighted average (by profit)	18.8	
Tesco/Sainsbury's average	19.5	

Table A2.2: statistics on price per store

(16 transactions)	Price per store (£m)	
Lowest	0.21	Co-op Group-Alldays
Highest	2.00	United Co-op-Leathleys
Average	0.65	
Weighted average (by store numbers)	0.42	
Tesco/Sainsbury's average	0.72	

APPENDIX 3: ACKNOWLEDGMENTS

Europe Economics held a number of discussions with players in the convenience sector and also received written information. We would like to acknowledge help received from the following:

Adrian Costain (an independent retailer)

Association of Convenience Stores

Booker

Nisa-Today's

Mills Group

Musgrave

Parfetts