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The Competition Commission inquiry into the grocery market

The investigation is already proving extraordinarily taxing for the Commission both in terms of scale and complexity

by Robert Young*

Background

The current Competition Commission (CC) inquiry into the grocery market is not, though media comment might suggest otherwise, just another investigation into supermarkets. It is true that, in recent years, the CC has given supermarkets a thorough going-over. But whereas the inquiries of 2000, 2003 and 2005 concerned only supermarkets per se, the current investigation covers the whole grocery sector, embracing also non-supermarket retailers, convenience stores, specialised grocery retailers, suppliers and wholesalers. This wider coverage is much to be welcomed. Supermarkets may account for some 72% of all grocery sales (and rising), but, in a market characterised by annual retail expenditure of over £120bn, the remaining 28% is non-trivial. In any event, the CC will want to consider whether or not the ratio of 72% to 28% represents a truly competitive outcome.

The genesis of the inquiry tells us something about the strength of conflicting views on the grocery sector. In 2004, the Office of Fair Trading reviewed the effectiveness of the Supermarket Code of Practice. This is a voluntary agreement that emerged from the CC 2000 inquiry and is intended to regulate relationships between the largest supermarkets (then the “Big Five”, now “Big Four” – namely ASDA, Morrison, Sainsbury and Tesco) and the primary producers that supply them. Although the OFT and a subsequent audit by accountants PKF concluded that the code was working, other views persisted. In March 2005, the OFT consulted more widely on “Supermarkets: the Code of Practice and Other Competition Issues”, and, in August, decided that there was no case for a market investigation reference to the CC. The Association of Convenience Stores disagreed, appealed and won. ACS’s success before the Competition Appeal Tribunal coincided with the arrival of a new chief executive at the OFT, Dr John Fingleton, who, to his credit, lost no time in making a market investigation reference under section 131 of the Enterprise Act. The inquiry began in May 2006, and the CC has a maximum of two years to report.

One cannot envy the CC the sheer weight of its task. As always, its conclusions will rest heavily on the evidence it gathers, and there is an immense amount of that to be unearthed from many disparate parties. The Big Four and other large retailers are easily contacted. But the UK is home to over 50,000 convenience stores, 40,000 other specialised

retail grocery outlets, 6,000 grocery suppliers and over 400 grocery wholesalers. These could all be counted as main parties to the inquiry, too. Even if the CC could engage directly with them all, how could it process the tidal wave of data that might come back? For dealing with smaller players, the CC has to treat with trade associations, many of which, having grown up as lobbying organisations, are thinly resourced and unfamiliar with mounting an economics-based or legally-based case. For them, the prospect of having to communicate with the UK’s top-level economic tribunal, and satisfy its voracious appetite for facts, is daunting.

This is a real conundrum for the CC. To put its findings beyond legal challenge, it must consider *all* the facts that bear upon the workings of the grocery market. But can it be sure that it has got all the facts if large numbers of small parties to the inquiry have a problem in assembling them? It would hardly be fair to take account only of evidence supplied by the bigger and better-resourced players. On the other hand, in assessing the position of smaller, less articulate players, should the CC extrapolate from the limited amounts of anecdote and allegation they are able to provide? That does not seem fair either.

How well, then, has the CC coped so far? One can gain a preliminary insight from its first main pronouncement, *Emerging Thinking*, a document of 60 pages plus eight working papers, published on 23 January 2007.

Emerging Thinking

The CC believes that retail grocery markets are local, as distinct from regional or national, though it has yet to pronounce on what “local” means. Interestingly, it has also shifted a long way from the binary definition of shoppers’ habits that it developed in 2000. One-stop shopping (the big weekly shopping trip) and top-up shopping (everything else) have given way to something much less easily categorised – a continuum of shopping habits exercised in a continuum of store types. In 2000, the CC defined a supermarket as a store supplying a wide range of grocery and other products in a retail space of at least 1400 square metres. At the opposite end of the scale, a convenience store is defined by an upper threshold of 280 square metres, an area also used for the application of Sunday trading laws. And there is much of interest going on in stores of between 280 and 1400 square

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metres, a category which includes such prominent names as Waitrose, Marks & Spencer and Aldi. So store sizes are no longer helpful in characterising shopping habits, either.

Emerging Thinking suggests that, while larger stores are a competitive constraint on smaller stores, smaller stores do not generally constrain larger ones. At the extreme, a corner shop may pose no real constraint on a hypermarket, but why, then, do larger stores sometimes pounce with deep-discount vouchers on smaller stores as soon as the latter seek to rise above their lowly station? The cases of Proudfoots in Withernsea and of Tuffins in Ludlow, both provoking what have been described as punitive reactions by Tesco, should give the CC reason to ponder not whether smaller stores *do* constrain the behaviour of big ones but whether they *can*, and, if not, why not. The OFT has argued that there are few barriers to entry in grocery retailing, which, at the lowest scale of entry, is almost certainly true. But what about barriers to expansion? Is it unreasonable for a Proudfoot or a Tuffin to aspire to take on one of the Big Four and win, or is there something in the grocery market that contrives to keep the big retailers big and the small ones small?

The answer might lie not at the retail level but at the wholesale. The CC places great weight upon the interests of the retail consumer – and rightly so – but the inquiry needs to consider also the mechanisms whereby retail consumers are served. Given the wording of the OFT's reference (“the supply of groceries by retailers in the United Kingdom”) it is reasonable that the CC should start with retailers. But as regards wholesale, Emerging Thinking is a curious piece of work. It is not clear whether the CC thinks there is even such a thing as a wholesale grocery market. A computer search for the phrase “wholesale market” (whether singular or plural) reveals no such occurrences in either Emerging Thinking or any of the working papers. The main document says (at paragraph 88) that, “Our proposed approach to the definition of upstream markets for the wholesale supply of groceries to grocery retailers should be noted.” But there is no such definition. The working paper on supply chain practices refers (at paragraph 53) to “the supply market” but that term neither leads to nor derives from a market definition. These might, of course, just be heat-of-the-moment editing lapses – after all, Emerging Thinking finally emerged rather later than the CC had originally intended.

But it is far more serious than that. Problems at the wholesale level go right to the heart of the complaints that small retailers and the wholesalers who supply them want the inquiry to explore. For them, the critical issue is the buying price differentials that exist between the supermarkets and themselves. It is not objectionable that there should be differentials: the questions are how big are they, and are they justified by the advantages of scale and presence that the supermarkets offer?

For the CC, an economic assessment of scale and other economies across a representative number of products need not be unduly complex, though it could be time-consuming. For a given product, all that is needed is a dataset of buying volumes and prices for different purchasers, knowledge of the other price and non-price benefits that buyers exact, and some estimates of the production and distribution volumes at which

economies of scale might reasonably be exhausted.

Once such advantages have been accounted for, are further differentials ascribable simply to market power? If the costs of trading terms exacted by the largest buyers are onerous, do suppliers seek to recoup them through higher prices to smaller buyers – what is sometimes called the “waterbed effect”? In fact, the term need not imply only that a supplier will raise prices to buyers who lack market power. Price effects may indeed occur, but so may a lack of innovation, along with the early exit of firms from the supply sector and a lack of new entry to it. The CC has provisionally concluded that the theoretical model of the waterbed may apply – but the task now is to test the theory with real-life data.

Buyer power – getting the evidence

The difficulty that is emerging, however, is not analysing the information but getting it – not just in relation to the waterbed effect but to buyer power generally. Thus the CC is faced with a prickly task, just as it was in 2000. Supermarkets do not want to reveal their buying prices or other trading practices, and, in order to deter suppliers from doing so, the CC has found (again) that supermarkets are fully prepared to exercise intimidation:

“Many suppliers and trade associations have spoken to us about a ‘climate of fear’ associated with making complaints about the four large grocery retailers. This was also a factor in the CC’s 2000 investigation as well as subsequent interactions between suppliers and the OFT concerning the operation of the Code. This has also been a factor in the current investigation...” (Emerging Thinking, para 72)

“Further, we note in paragraph 72 that suppliers have told us that they are not willing to come forward with evidence [of unilateral changes to contract terms] for fear of retaliation by their main customers.” (ibid. para 123)

In this inquiry the CC has tried hard to obtain evidence, not only through hearings but also by means of two substantial surveys, one of its own making and the second commissioned from a specialised market research firm.

The CC's own survey consists of a large-scale and highly detailed supplier questionnaire drafted in September 2006. It diligently consulted other parties on the content of the questionnaire before sending it out. The CC has revealed little, however, about its fate. It has not said how many suppliers it sent the document to, nor how many declined to respond, nor much about the few answers that came back. Emerging Thinking mentions 15 responses, but not who the respondents are, nor what product groups are covered, nor whether the CC regards them as representative of groceries generally. The evidence of the 15 respondents is that bigger buyers do not get better prices than smaller buyers, a finding that the CC admits is inconsistent with its findings in 2000. But it does not then explore the inconsistency. Independent wholesalers and smaller retailers find all this astonishing. The CC's 2000 report records that a buying price difference of around 11% then prevailed between the largest supermarket group, Tesco, and a large independent wholesaler/retailer, Budgens. In the current inquiry, the Federation of Wholesale Distributors has submitted that the differential has now

widened to at least 15%, probably more. How on earth, it asks, could buying price differentials have been effectively eliminated, especially when supermarkets have continued to increase their market share? For the effort it applied, the CC (let alone non-supermarket buyers) must surely hope that more is yet to come from the questionnaire?

The second survey is one that the CC commissioned from GfK/NOP (formerly known as NOP). GfK carried out field work between 9 October and 6 November 2006; its report is dated 18 December; and the CC posted the headline results on its website that same month. The CC does not explain how the GfK survey ties up with its own. It seems unlikely that this second survey aims to make up for problems arising from the first, given that GfK's questions do not cover quite the same ground as the CC's. What is striking, however, is that GfK was able to get so many responses – 456, including detailed interviews with 51 suppliers, compared with the CC's 15.

Emerging Thinking nevertheless shows the CC still valiantly encouraging suppliers to come forward:

“...we would encourage other suppliers with information relevant to the inquiry and that have concerns to discuss them with us. We are confident that we will be able to meet any concerns suppliers may have in relation to confidentiality issues.” (para 102)

Its assurances of confidentiality do not appear to have led very far. Sooner or later, the CC will need to decide whether to use its statutory powers under section 109 of the Enterprise Act to compel the production of information. In principle, it could get the detail it needs from suppliers or from their customers, though it would be characteristic of the CC to compare responses from both sides. If the CC does use its statutory powers, the timetable that it is seeking to work to, which would see the inquiry completed five months inside the time allowed by the Act, is probably in jeopardy. If it does not, and the CC reaches conclusions only from evidence supplied voluntarily, there must be a risk of legal challenge. In the vernacular, the CC is caught between a rock and a hard place.

Land and planning issues

The terms of reference handed to the CC also require it to consider the competitive impacts of landholding and planning. Neither had figured in the OFT's preceding consultations on grocery retailing, although the subject had arisen in the CC's 2000 report on supermarkets:

“By far the severest constraint on a grocery retailer seeking to enter, or expand within, the grocery retailing market is the shortage of sites suitable for development, exacerbated by aspects of the planning system” (para 2.199).

The CC's 2003 report on Safeway repeated and reinforced this finding. Then, in December 2006, the publication of The Barker Review of Land Planning – Final Report gave a new twist to planning issues. Among other things, Barker argues that the “needs test” for edge-of-town and out-of-town developments has impeded the expansion of supermarkets, by implication a bad thing. The CC needs to examine whether and how this impediment bears upon competition and whether adverse competition effects would arise if the test

were abolished. If the answer is yes, it will need to devise a solution within its own competence. All this is a very tall order. The CC is still in process of gathering essential information from local planning authorities, so Emerging Thinking does not go very far on planning.

It is generally the case that neither independent wholesalers nor smaller retailers seek to acquire the large sites for development that supermarket groups do. But if, as Barker urges, supermarkets are freed from the obligation to pass the needs test for non-town-centre developments, a likely consequence is that yet more grocery market share would accrue to supermarkets. It is conceivable that competitive intensity between supermarkets would increase: indeed, Sainsbury's believes that Tesco, given its existing land holdings, might extend its grocery market share from 30% to 43%. The CC thinks Sainsbury's estimate of 43% too high but has nevertheless modelled increases of its own. The CC is normally reluctant to base important conclusions on forecasts but in this case it may have little choice: if a relaxation of planning restrictions is in the offing, the CC can hardly avoid assessing the likely consequences.

It will need to consider the competitive impact of possible shifts in market share within the Big Four, and whether an increase in the supermarkets' aggregate share of grocery retailing would damage other types and sizes of retailer to a point where consumer choice and town centre vitality are threatened (or further threatened). If further shifts take place towards out-of-town supermarket retailing, questions arise as to how that affects those consumers who have difficulty in making the necessary journeys, and whether supermarkets should also acquire an increasing share of town-centre grocery retailing through the ownership of convenience stores. Tesco, it is pointed out, is not only by far the biggest of the Big Four supermarkets but, among that group, also owns by far the largest number of convenience stores.

Some have asserted that, especially in the Emerging Thinking material on planning and land holdings, there is an acceptance by the CC, albeit only subliminally visible, that the presence of the Big Four in the UK grocery market is somehow the natural order of things, and that their continued accretion of market share is neither resistible nor objectionable. At such an early stage of the inquiry, this may be an unduly harsh judgment on the CC, but its further treatment of landholding and planning issues should do much to clarify whether there is any substance to it.

The problem of finding remedies

This whole inquiry is, without doubt, extraordinarily taxing for the CC, on grounds both of scale and complexity. Getting all the relevant evidence is already proving problematic, and the apparent disinclination of some parties to provide it is likely to continue to test the CC's resolve as well as its timetable.

Even when it has done all that it can, and has reached conclusions on whether adverse effects arise, finding workable remedies may prove no less daunting. The panel in 2000 found certain matters operating in a manner adverse to the public interest, but, unusually, could devise no suitable remedies. If adverse effect are identified this time, one hopes that the present panel will do better.