# The UK Competition Commission's Groceries Market Investigation: Market Power, Market Outcomes and Remedies

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Presented at the 27th International Association of Agricultural Economists Conference
Beijing, China

August 16-22, 2009

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*16 July 2009*

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# 1. Introduction

## 1.1 The CC Market Investigation Regime[2]

The Competition Commission's (CC) market investigations typically take between 18 months and two years to complete. They are comprehensive and determinative investigations into particular markets that may consider all aspects of the market and market participants. Since EA02 came into force in 2003, the CC has completed nine market investigations. Market investigations have a broad scope in terms of subject matter. They enable the CC to look in the round at markets where it may be thought competition is not working well and the regime acts as an important complement to the prohibition system established by the Competition Act 1998 ("CA98") which is based on the prohibitions in Articles 81 and 82 of the EC Treaty.

The CC's investigation into the UK groceries sector was a market investigation under the provisions of the Enterprise Act 2002 (EA02), which requires the CC to decide under Section 134(1) whether "any feature … of each relevant market prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK." Where the CC identifies such a feature there is said to be an 'adverse effect on competition' ("AEC"), and the CC then decides on the action, if any, that should be taken by itself or by others to remedy, mitigate, or prevent the AEC. Remedies can be structural or behavioural or may involve the CC recommending that action be taken by others, e.g., regulatory bodies or changes to government regulations or legislation.

The features identified can relate to market structure, firm conduct or consumer conduct. The types of market situation that the regime can deal with include: *unilateral and coordinated effects* that fall short of the abuse of dominance or the illegal agreements prohibited under CA98; *vertical effects*, covering market structure issues in which parties operate at different levels of the supply chain; *informational failure*, in which consumers lack information to make suitable choices; *barriers to entry,* including those created by government policy, which, although often motivated by legitimate public policy considerations, may distort competition; or *inefficient equilibria*, in which a market arrives at a bad equilibrium from which no individual firm has an incentive unilaterally to deviate. The CC implements its part of EA02 which involves a regime where the focus is very much on diagnosis and cure rather than prohibition or punishment. Specifically, firms active in the market in question do not, even potentially, face large administrative penalties as would be the case with an investigation into a potential breach of CA98, although of course the CC's remedies may not always be to their liking, e.g., price controls (Classified Directory Advertising Services) or forced divestments of major assets (BAA Airports).

## 1.2 Concerns about the sector

Before the reference of the market to the CC for investigation, various concerns had been expressed about the sector. In relation to horizontal issues, these included concerns about the effect of supermarkets on convenience stores and on other small retailers (e.g., butchers, bakers, greengrocers), as well as the effects of the expansion of large grocery retail chains into the convenience store sector. Whether the strong market position of Tesco gave it some kind of anti-competitive or unfair advantage was also raised. Concerns in relation to vertical issues revolved around the relationships between large grocery retailers and their suppliers, including the effectiveness of the Supermarkets Code of Practice (SCOP) that governed these.[3]

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[2] For a discussion of the UK market investigation regime, see "Investigating Markets and Promoting Competition: the Competition Commission's Role in UK Competition Enforcement", Beesley Lecture by CC Chairman, Peter Freeman, 18 October 2007: www.competition-commission.gov.uk/our_role/speeches/pdf/freeman_beesley_181007.pdf.

[3] The SCOP was introduced following an earlier investigation into the sector by the CC: www.competition-commission.gov.uk/rep_pub/reports/2000/446super.htm.

Naturally, various non-competition concerns were raised too, for example, the environmental impact of grocery retailing – in terms of excess packaging, plastic shopping bags, product wastage and the long-distance transportation of products, especially by air. The working conditions of agricultural workers in the UK and in countries that supply the UK was also raised. A common concern was the influence of the grocery market on society's eating and drinking habits, e.g., low price unhealthy food and low price alcohol. In general the CC's remit in a market investigation is limited to competition concerns.[4]

**1.3 The UK grocery retail sector**

In 2007, an estimated £110 billion of grocery sales in the UK were made through almost 100,000 grocery stores, including both supermarkets and convenience stores.[5] Just over 65 percent of UK grocery sales were made by the four largest grocery retailers (Asda, Morrisons, Sainsbury's, and Tesco) from a combined total of around 3,600 stores. A further 20 percent of sales were shared among 4,000 stores belonging to an additional four grocery retailers (The Co-operative Group (Co-op), Marks & Spencer (M&S), Somerfield, and Waitrose). Within this group of eight large grocery retailers there is a degree of product differentiation. For example, M&S and Waitrose place an emphasis on high quality products, while Asda emphasizes its price competitiveness. There is also differentiation in terms of the store formats offered by each of these retailers. For example, Asda and Morrisons operate very few stores smaller than 1,000 sq. meters (approx. 10,800 sq. feet), while Sainsbury's and Tesco operate large and mid-sized supermarkets as well as convenience stores.

There are a number of other grocery retail chains that differentiate their product from mainstream grocery retailers. One example is the Limited Assortment Discounters ("LADs") that are active in many grocery retail markets in Europe, offering a limited range of grocery products at very low prices. The major LADs in the UK are the German chains Aldi and Lidl and the Danish-owned Netto. Together, Aldi, Lidl, and Netto operate around 1,000 stores in the UK and generate around £3.1 billion in annual sales. A further group of grocery retailers in the UK that engage in a substantial degree of product differentiation from mainstream grocery retailers are the frozen food retailers, who offer a substantial range of frozen products, including red meat, fish, chicken, vegetables, ready meals, desserts, and other products, as well as a more limited range of fresh produce and dry goods. The UK's largest frozen food retailer is Iceland, which has around 680 stores and annual sales of approximately £1.6 billion.

There had been a number of CC investigations into the grocery retail market in the years before the 2008 Groceries Market Investigation. An investigation into supermarkets reported in 2000, under the Fair Trading Act 1973 "complex monopoly" regime, rather than the current market investigation regime. There were also three prominent merger investigations in the sector in recent years. The CC investigated the merger situation arising from four competing bids for Safeway from Asda, Morrisons, Sainsbury's and Tesco.[6] In 2005, the CC investigated the acquisition by Somerfield of 115 Morrisons stores.[7] The CC also investigated the acquisition by Tesco of a former Co-op store in Slough, whilst the Groceries Market Investigation was ongoing.[8]

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[4] Concerns about issues other than competition commonly arise and the CC is not blind to this. For example, see "Is competition everything?", a speech by CC Chairman, Peter Freeman, to the Law Society European Group: www.competition-commission.gov.uk/our_role/speeches/pdf/freeman_law_society_210708.pdf.

[5] Convenience stores were defined as grocery stores smaller than 280 sq. metres.

[6] CC Final Report was published in 2003: www.competition-commission.gov.uk/rep_pub/reports/2003/481safeway.htm.

[7] CC Final Report: www.competition-commission.gov.uk/rep_pub/reports/2005/501somerfield.htm.

[8] CC Final Report was published in 2007: www.competition-commission.gov.uk/rep_pub/reports/2007/534tesco.htm.

### 1.4 Conduct of the investigation and the CC's findings

The Office of Fair Trading, the UK's other principal competition authority, initiated a market study whose outcome was a reference to the CC for a full market investigation in May 2006. The CC published its Final Report on 30 April 2008. It is worth noting the scale of the investigation. The Final Report itself is 266 pages long, plus a further 666 pages for 36 appendices. CC staff prepared 26 working papers prior to the CC issuing its Provisional Findings.[9] The conduct of the investigation included: a number of surveys of suppliers to grocery retailers, LPAs and the local retail offer; the construction of a data set of 14,000 UK grocery stores covering more than 30 variables (including location, revenue, costs, sales area, product rage, prices and store amenities); the consideration of more than 700 submissions from main and third parties; dealing with 21 main parties; holding 80 hearings with main and third parties at the CC in London and in Scotland, Wales and Northern Ireland; numerous write-in campaigns (Action Aid, Friends of the Earth, Tesco, Tescopoly); more than 25 site visits; and a number of roundtable discussions with academics and suppliers.

The main findings were that "…, in many important respects, competition in the UK groceries industry is effective and delivers good outcomes for consumers, but not all is well. We have concerns in two principal areas. First, we found that several grocery retailers have strong positions in a number of local markets. Barriers faced by competing grocery retailers that could otherwise enter these markets mean that consumers get a poorer retail offer in terms of prices, quality and service than would otherwise be the case, while those grocery retailers with strong local market positions earn additional profits due to weak competition in those markets."[10]

"Second, we found that the transfer of excessive risk and unexpected costs by grocery retailers to their suppliers through various supply chain practices if unchecked will have an adverse effect on investment and innovation in the supply chain, and ultimately on consumers."[11]

In relation to competition between large grocery chains and convenience stores, the CC stated that: "It is clear that the process of competition can be challenging, and in some cases, even leads to the closure of businesses. But, however sympathetic we may be to the effects of such pressure, we must, as a competition authority, assess the effects of the process of competition on the interests of consumers. Having examined thoroughly the full range of concerns that have been raised with us regarding possible distortions in competition between large grocery retailers and convenience store operators, we did not find that these concerns were substantiated."[12]

This paper focuses on four areas of the CC's report. First, in Section 2, we look at local market concentration, outlining how the CC arrived at its product and geographic market definition, its analysis of concentration and the assessment of the economic effects of local market concentration. Second, Section 3 outlines the CC's analysis of competition between supermarkets and convenience stores. This leads on to the assessment of vertical issues in Sections 4, focussing on buyer power and its effects on suppliers and on competition at the retail level. The CC assessed buyer power in relation to three possible effects: the waterbed effect that may result in market share shifting towards large grocery retailer chains; the effect of contractual incompleteness and supermarkets' supply chain practices on investment and innovation in the grocery supply chain ("ex-post hold up"); and demand withholding by retailers. We then outline the remedies that the CC decided upon in response to the features of the market which it identified, while we finally conclude in Section 6.

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[9] See: www.competition-commission.gov.uk/inquiries/ref2006/grocery/provisional_findings.htm.

[10] Paragraph 2 of the Final Report.

[11] Paragraph 3 of the Final Report.

[12] Paragraph 6 of the Final Report.

## 2. Local Market Concentration

This section begins by setting out how the CC defined the relevant product and geographic markets in relation to the supply of groceries. We list the main evidence involved, give a little more detail (given the space constraints of this paper) in relation to some of the more interesting economic evidence and then set out the CC's findings. Having defined the relevant markets, we briefly present the CC's work on identifying those local markets that were highly concentrated and in assessing the economic effects of that concentration.

### 2.1 Market Definition

Defining the product and geographic markets in which grocery stores compete provided an important building block for analysis in the CC's groceries market investigation. In particular, it provided the framework for the CC's analysis of competition among grocery retailers.

The CC used the hypothetical monopolist or SSNIP ("small but significant non-transitory increase in price") test in reaching its market definition findings. In competition analysis, a market is defined as something worth monopolising and the test aims to identify the scope of such a market. The various pieces of evidence and analysis outlined below were used to come to an overall assessment of likely consumer behaviour in response to a prices increase, with a view to determining whether a hypothetical monopolist could profitably impose a SSNIP. The SSNIP test provided a conceptual framework rather than being a test that was applied directly in a single model on which the CC relied for its findings.

*Product Market Definition*

In defining the product market for grocery retailing the CC focused on two observable variables, store size and the identity of the store operator (store fascia), that it considered captured many of the factors that differentiate one grocery store from another.

In assessing the extent to which stores of different sizes place an effective competitive constraint on each other, such that they should be included in the same product market, a range of evidence, relating to both product and demand characteristics, was analysed:

(i) the extent to which the number of product lines (or stock-keeping units – "SKUs") in a store varies with store size;

(ii) the presence of different food counters and other amenities in stores of different sizes;

(iii) the store size distributions of grocery stores in the UK, as well as within the portfolios of individual grocery retailers;

(iv) consumer shopping patterns in relation to different store sizes;

(v) an econometric model of consumer demand for groceries (outlined below); and

(vi) the impact of the entry of new grocery stores on the revenues of different-sized grocery stores.

In assessing the extent to which stores operated by different retail chains place an effective competitive constraint on each other, to the extent that they should be included in the same product market, the CC considered evidence in relation to:

(i) grocery retailers' monitoring of their competitors;

(ii) an analysis of the effect that entry by grocery stores belonging to particular retailers had on other retailers' store revenues (the entry analysis);

(iii) an econometric model of consumer demand; and

(iv) a general consideration of the product range offered by different grocery retailers.

*Geographic Market Definition*

As with the relevant product market, the hypothetical monopolist test or SSNIP test is the appropriate conceptual framework for considering the geographic market. The relevant geographic market for grocery retailing is the smallest collection of stores (often expressed as a geographic area), which could, hypothetically, be monopolized profitably. In considering the geographic market, the hypothetical monopolist test looks at whether a profit-maximizing hypothetical monopolist could impose a SSNIP on a narrowly defined set of stores that are in the same product market. If a SSNIP would not be profitable because customers would switch to stores in neighbouring areas, these stores are added to the geographic market and the procedure is repeated

The CC's consideration of the relevant geographic market included examining evidence in relation to:

(i) retailers' assessments of the geographic scope of competition;.

(ii) the scale of national and local competitive initiatives by grocery retailers;

(iii) consumer shopping patterns and catchment areas for grocery stores;

(iv) a model of consumer demand for groceries;

(v) geographic variations in store-level profit margins;

(vi) the impact of new store entry on the revenues of incumbent stores;

(vii) a model submitted by Tesco that seeks to simulate the effect of store-level price increases; and

(viii) the impact of Internet-based grocery shopping.

While we would ideally outline in some detail some of the economic evidence listed above, space constraints mean that we move straight from listing the relevant evidence to presenting the CC's findings on market definition, though we hope that the lists above give an idea of how these decisions are made. The CC's market definition findings were as follows:[13]

"We identified three major product markets for the supply of groceries by grocery retailers in the UK that provide the framework for our analysis:

a) for larger grocery stores, other larger grocery stores (i.e., stores larger than 1,000 to 2,000 sq metres) are in the same product market;
b) for mid-sized grocery stores, other mid-sized and larger grocery stores are in the same product market (i.e., all stores larger than 280 sq metres); and

[13] See paragraphs 12 to 16 of the Final Report.

c) for convenience stores, all grocery stores (i.e., convenience stores, mid-sized and larger grocery stores) are in the same product market."

"The precise delineation of the product market by store size differs across local geographic markets depending on factors such as the distribution of stores of different sizes in each particular local market, store amenities, opening hours and other facets of the retail offer. For the purpose of analysing collectively a large number of local markets, we in many cases used a 1,400 sq metre threshold for larger grocery stores."

"In each local market, stores operated by any of the large grocery retailers (Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose), regional grocery retailers (such as Booths and regional Co-ops) and symbol groups (such as Budgens and Spar) will be in the same product market—provided that the store in question meets the local store-size threshold for inclusion. A number of grocery retailers, due to their limited product range, fall outside the three markets referred to above. These include: Limited Assortment Discounters, primarily Aldi, Lidl and Netto; frozen food retailers such as Iceland and Farmfoods; and specialist grocery retailers such as butchers, fishmongers and greengrocers."

"We concluded that the geographic market for the supply of groceries by grocery retailers was local. In relation to the three product markets that we identified:

a) Larger grocery stores will, in general, be constrained by other larger grocery stores within a 10- to 15-minute drive-time.
b) Mid-sized grocery stores will, in general, be constrained by other mid-sized grocery stores within a 5- to 10-minute drive-time and by larger grocery stores within a 10- to 15-minute drive-time.
c) Convenience stores will, in general, be constrained by other convenience stores within a 5-minute drive time, by mid-sized grocery stores within a 5- to 10-minute drive-time and by larger grocery stores within a 10- to 15-minute drive-time."

"The precise delineation of the geographic market varies across local markets according to local topographic and other conditions, such as the distribution of the population relative to the stores in the area. For the purposes of analysing a large number of local markets, however, we used a threshold of either 10 or 15 minutes' drive-time as appropriate."

**2.2 Market structure and concentration**

There are a number of ways to measure market concentration, such as counting the number of competitors in a market, or assessing the relative size of competitors as measured by sales shares and indices, such as concentration ratios or the Herfindahl-Hirschman Index, which reflect both the number of firms in a market and their relative size. For the purposes of assessing the extent of concentration in local markets for grocery retailing, the CC used two distinct measures:

- retailers' shares of groceries sales area as a proxy for share of sales; and

- the number of competing fascias.

In assessing the extent of local market concentration, the CC focused on those local markets with three or fewer fascias in total, where one of those fascias had a share of local grocery sales area that is greater than 60 per cent within a 10- or 15-minute drive-time. These were defined as 'highly-concentrated local markets'.

*Evidence on the economic effects of concentration*

The CC examined the extent to which grocery retailers that are present in several local markets adjusted their store-level retail offer on the basis of local competitive conditions, and, in particular, to the level of local market concentration. In principle, grocery retailers have an incentive to weaken their retail offer in those markets where competition is less intense. In practice, varying the retail offer locally involves administrative and other costs and many of the elements of the retail offer are supplied uniformly or near uniformly at the national level, including, for most large retailers, pricing. However, the intensity of local competition may still be expected to influence the retail offer in two ways:

- through influencing those element of the retail offer that are determined locally, such as store refurbishments in response to entry, some chains use multiple price bands, provision of fish counters, etc.

- through influencing the overall level at which nationally uniform components of the retail offer are set.

Alongside, an assessment of the qualitative evidence on variations in the retail offer in local markets, the CC took account of three studies:

(i) An econometric analysis, submitted by Tesco, using data for a number of its own stores;

(ii) A survey by market research company, GfK, commissioned by the CC; and

(iii) An econometric analysis of store-level profit measures conducted by the CC.

Tesco submitted an analysis of the relationship between local concentration and a number of proxies for the local retail offer for 156 of its own stores. These proxies included the range of products, sales per staff member (as a proxy for service levels), the number of customer facilities in store and time since refurbishment. Their control variables included net sales area, the presence of toilets, ATM or petrol forecourt and mean income in the isochrone. Their regression analysis used population within the isochrone as an instrumental variable for local concentration. Tesco concluded that their analysis showed that there was no relationship between the store-level retail offer and local concentration.

The GfK study assessed the extent to which 18 individual aspects of the retail offer at stores larger than 1,400 sq metres varied across 44 locations in the UK with different degrees of retailer concentration. Most of these aspects of the retail offer were store-specific, although pricing, which would be expected to be largely uniform across areas regardless of concentration given the current pricing policies of most grocery retailers, was also included in the study. The study detected relatively little variation in the retail offer across local areas. While product range was marginally better in those stores where there was more than one competing retailer, as the study was able to include only a limited number of products it is difficult to draw strong conclusions regarding this effect.

The CC conducted an econometric analysis of the relationship between store-level variable profit and local market concentration, where profit is treated as a proxy for the retail offer, on the basis that the variable profit margin will change with any price change, as well as in response to any change in product range (to the extent that different products have different margins) and can reflect local promotional activities or higher service activity, as these cause stores to incur costs. The CC analysis used data on store-level margins for stores over 280 sq metres for the four largest retailers: Asda, Morrisons, Sainsbury's and Tesco. The data were cross-sectional for the period May 2005 to April 2006, using yearly averages for the variable profit margin. Four concentration measures are used:

(a) number of competitor fascias within a 10-minute isochrone;

(b) number of of competitor stores within a 10-minute isochrone;

(c) combined net sales area of competitor stores within a 10-minute isochrone; and

(d) share of competitors' net sales area within a 10-minute isochrone.

As the firm's entry decision, as well as that for its competitors, is affected by expected profits, the competitor variables are likely to be endogenous, total population and the population density of the isochrone are used as instrumental variables.

The main results are presented in Table 1.

Table 1: **Impact of local concentration on store profit margins**

| | *Number of competitor fascias with stores over 280 sq metres within 10 mins* | *Number of competitor stores within 10 mins* | *Combined net sales area ('000) of competitors within 10 mins* | *Share of competitors' net sales area in total net sales area within 10 mins* |
|---|---|---|---|---|
| Effect on store profit margin | –0.0096*** | –0.0036*** | –0.0027*** | –0.1548*** |
| t-statistics | (–2.74) | (–2.65) | (–2.82) | (–2.75) |

*Source:* CC analysis.

**p* <0.10; ** *p* <0.05; *** *p* <0.01.

*Source*: Appendix 4.4, Table 1.

These results indicate that each additional fascia reduces variable profit margin at the centre store by 0.96 per cent. When the number of competitor stores within a 10-minute isochrone is used as the concentration measure, the results indicate that each additional store reduces variable profit margin by 0.36 per cent. Using the combined net sales area of competitors in the isochrone, the results suggest that each additional 1,000 sq metres of competitor sales area reduces store margins by 0.27 per cent. Using the share the competitors' share of total net sales area in the isochrone, the results imply that, with symmetric competitor stores, entry of a competitor store of 1,000 sq metres where the local incumbent monopoly store is also 1,000 sq metres reduces the monopolist store margin by 7.7 per cent. Adding a second rival store of the same size—that is, 1,000 sq metres—further reduces the margin of the centre store, but by only 2.6 per cent; while adding a third rival reduces the margin by 1.3 per cent. As this example suggests, the effect of the first entrant and following entrants will be different.

Overall, this empirical analysis found that local market structure had an impact on store variable profit margin. For larger grocery stores, the CC estimated that an additional competitor fascia reduces a store's variable profit margin by 3.79 per cent. This effect translates into an annual profit loss between £303,138 and £354,054 for a larger grocery store of average size. Compared with the average larger grocery store annual profit of £6,758,652, this effect appears small but it, in the CC's view, it is economically significant. "Based on a mid-point estimate of approximately 350 larger grocery stores in highly-concentrated local markets, this equates to additional profits for the grocery retailers operating these stores of approximately £105–£125 million a year. This represents around 3 per cent of the combined annual profits of £3.6 billion that the four largest grocery retailers earned in 2007 from UK grocery retailing. (The four largest retailers own approximately 85 per cent of the larger grocery stores in highly-concentrated local markets)".[14] The CC were of the view that the additional store level profits at mid-sized stores as a result of weak local competition were of a similar order. There were also likely to be further additional profits as a result of prices being higher at all stores (not just those in highly-concentrated local markets) due to the national pricing strategies of the large retail chains. While estimating what the scale of this national price effect was would be difficult, as an illustrative example, for each 0.1 per cent increase in prices the four largest grocery retailers earn an additional £80 million per year.

The findings from the CC's margin-concentration analysis were supported by qualitative evidence provided by grocery retailers, e.g., store refurbishments and improved staffing levels were found to be common responses to new entry locally. Retailers told the CC that other changes such as the addition of a fish counter or other amenities, extending opening hours or the provision of bag packers are also made in response to local competitive conditions.

In relation to both the Tesco and GfK studies, the CC was not confident that the measures that were included in those studies were capable of fully reflecting all the different aspects of the store-specific retail offer. As a result, more weight was placed on the CC's own analysis.

In relation to the concerns raised by many parties about the strong market position of Tesco, the CC did not find there to be competition concerns that apply to Tesco over and above those that apply to other grocery retailers. The CC's assessment was that "the basis of Tesco's position is not insurmountable; there is nothing that Tesco does that could not, over time, be challenged by competitors. There is a risk that at some point in the future the number of Tesco stores that do not face strong competition increases and there would be further deterioration of the retail offer that would harm consumers. Such a development could also take place with any other large retailer. We expect our remedies to contribute to preventing such a situation occurring."[15]

## 3. Competition between Supermarkets and Convenience Stores

The Association of Convenience Stores (ACS) argued that the number of convenience stores was declining as a result of unfair competition from supermarkets. In response to this, the CC examined a number of possible causes of competitive distortion: below cost selling, local vouchering by supermarkets, the financial viability of the grocery wholesale sector, Tesco and Sainsbury's expansion into the convenience store sector and buyer power and the waterbed effect.

While this paper will focus on the issue of buyer power and the waterbed effect, it is worth very briefly mentioning the CC's findings in relation to the other possible causes of competitive distortion:

Below cost selling by large grocery retailers was found to be quite common. However, the CC found that the pattern of below-cost selling it observed by large grocery retailers did not represent behaviour that was predatory in relation to other grocery retailers and did not give rise to any other AEC.[16] It also concluded that it was not likely to mislead consumers about the cost of shopping at a store – basket prices are also important

[14] See paragraph 6.54 of the Final Report.
[15] See paragraph 8 of the Final Report.
[16] See paragraph 5.68 of the Final Report.

and that temporary promotions, including loss leading, may constitute efficient pricing for retailers, and may reduce the average price for a basket of products.

Local vouchering was found to be not particularly extensive and did not form part of a pattern of activity that might be considered predatory or otherwise have an adverse effect on competition.[17]

In relation to the expansion of Tesco and Sainsbury's into the convenience store sector, the CC did not find that their expansion was anti-competitive, and to the extent that it has resulted in increased competition, consumers will have benefited. The CC did not find that their expansion into the sector weakened the competitive constraint on Sainsbury's or Tesco such that it led to a deterioration in their retail offer (either at their convenience stores or other grocery stores) or a loss of choice in grocery stores for consumers.[18]

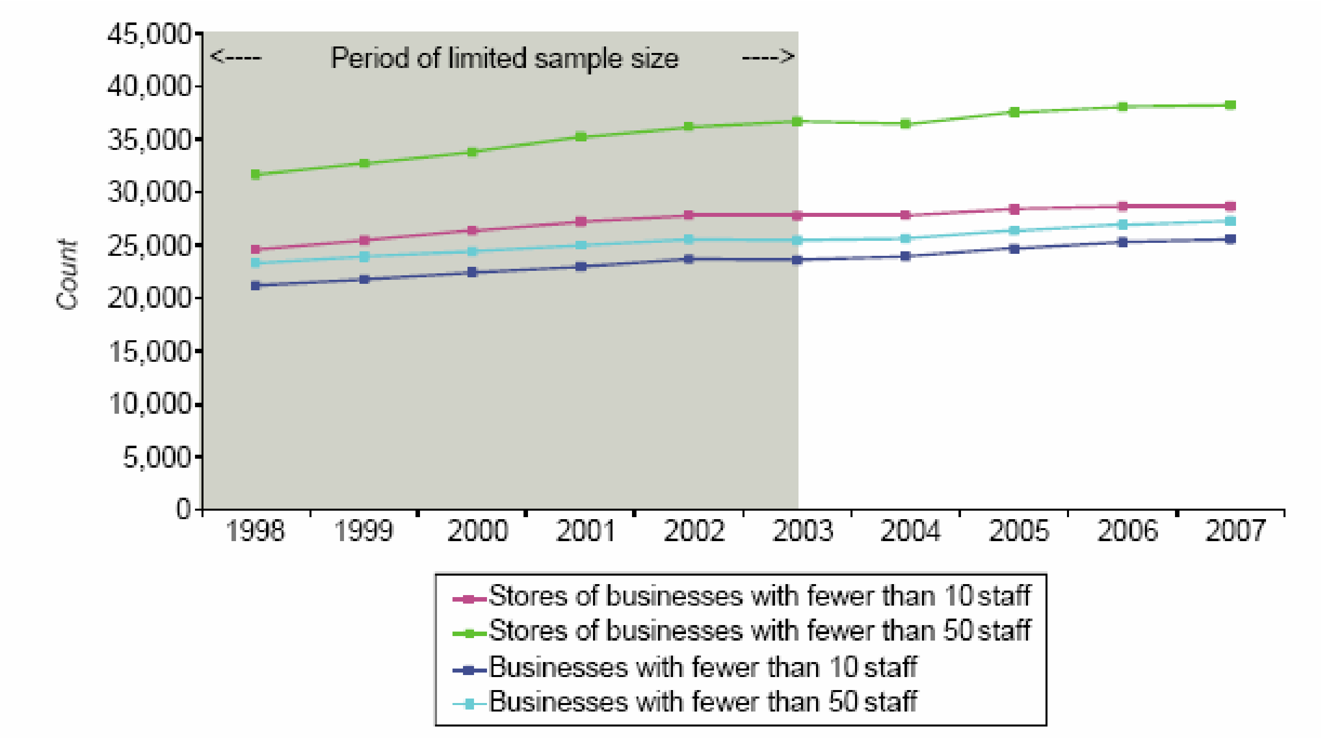
The CC, on the basis of its analysis of the current and projected financial performance of the grocery wholesaling sector, concluded that the financial viability of the sector as a whole was not seriously threatened.[19]

Robust identification of a trend in convenience store numbers was a major point of contention. Data from a number of sources were considered when analysing the trends in the number of convenience and specialist stores. The CC focussed their analysis on Office of National Statistics (ONS) data and concluded it was this was the only consistent data set that allowed accurate comparison over time.

As presented in Figure 1, among the key trends to emerge were that (i) the number of convenience stores operated by small businesses increased by 3 per cent between 2003 and 2007 and (ii) the number of these businesses has increased by 8 per cent.

[17] See paragraph 5.86 of the Final Report.
[18] See paragraph 21 of the Final Report.
[19] See paragraph 5.51 of the Final Report.

Figure 1: **Trends in the number of convenience stores and businesses**




*Source*: Appendix 5.1, Figure 1: ONS, IBDR data – from *UK Business: Activity, Size and Location* 2004-2007.

## 4. Buyer Power

As a general phenomenon, the economic effects of buyer power tend to be beneficial to consumers, as it leads to reduced upstream prices, which, in turn, tend to (at least in part) pass through to lower prices for final consumers, as a result of competition between buyers acting as sellers. The CC assessed the extent and effects of buyer power among large retail chains in relation to three areas:

(i) the existence of a waterbed effect that disadvantaged small retailers, leading to higher prices at these small stores and ultimately less choice for consumers;

(ii) the problem of contractual incompleteness between retailers and suppliers and how this can affect investment incentives in the supply chain; and

(iii) the possibility of demand withholding by large retailers.

### 4.1 Buyer power and the waterbed effect

In the context of the UK groceries market, the Association of Convenience Stores (ACS) put forward a model of a 'waterbed effect' in supplier pricing to grocery retailers which would harm consumers both in the short- and long-run.[20] A 'waterbed effect' occurs if large retailers negotiate prices reductions, which are not cost-related, from their suppliers who then increase prices to smaller grocery retailers and wholesalers. In the ACS model retailer size determines the extent of buyer power and hence the scale of the discounts large retailers can negotiate. These discounts allow large retailers to attract additional business, some of it at the expense of small retailers. If small retailers' sales fall then the discounts they can negotiate from suppliers

[20] See the paper by Europe Economics and Roman Inderst, "The 'Waterbed Effect': How Non-Cost Related Discounts to Large Retailers Can Harm Consumers", submitted to the CC on behalf of the ACS: [www.competition-commission.gov.uk/inquiries/ref2006/grocery/pdf/main_party_submissions_acs_waterbed_effect.pdf](www.competition-commission.gov.uk/inquiries/ref2006/grocery/pdf/main_party_submissions_acs_waterbed_effect.pdf).

decrease and so the gap between supplier prices for large and small retailers widens further. The model implies that the 'waterbed effect' will be greater:

(a) the more the growth in the large retailers' market share is at the expense of small retailers, rather than through market growth;

(b) the larger the initial discount obtained by large retailers; and

(c) the greater the market share of the larger retailers.

In the ACS model "[t]he overall impact on consumers will depend on the detailed market circumstances but we set out the conditions in which the overall balance between reductions in price by larger retailers and increased prices in smaller outlets results in a net increase in the average price paid and a net loss of benefit to consumers."[21] The ACS paper goes on to outline the circumstances where the net effect on consumer surplus is negative, as the effect of higher prices at small retailers dominates the lower prices charged by large retailers.

The long-run effects are driven by the idea that, while suppliers will recoup (from smaller retailers) some of the loss in revenue caused by the exercise of buyer power, they will still see a reduction in profits and some suppliers are likely to exit.[22] This will lead to less choice and a further weakening in the bargaining position of small retailers and wholesalers. Non-price effects are also likely as suppliers may respond to their profits being squeezed by reducing their product range or reducing investment and the promotion of new products.

The CC looked at evidence on the dynamics in market shares of large and small retailers, as well as evidence of the extent and determinants of buyer power, particularly the relationship of prices paid to suppliers and retailer size.

*Supplier Pricing*

To assess the causes of variation in supplier prices, the CC collected detailed pricing, volume and (where possible) cost data from 29 suppliers recorded at the SKU level for a period of up to five years. The data covered 141 branded-SKUs, representing £1.8bn annual sales at wholesale prices. This was equivalent to approximately 2 per cent of total UK groceries sales. Data on promotional discounts and other payments were also collected. Two price measures were generated:

- a unit price that was net of all discounts that were largely variable in nature and, therefore, "net of settlement discounts, all types of variable promotional support and any overriders that are linked to volume or value of sales (including growth targets)".[23] Economic theory suggests that retailers will usually only have an incentive to pass through discounts that directly affect the unit price it pays.

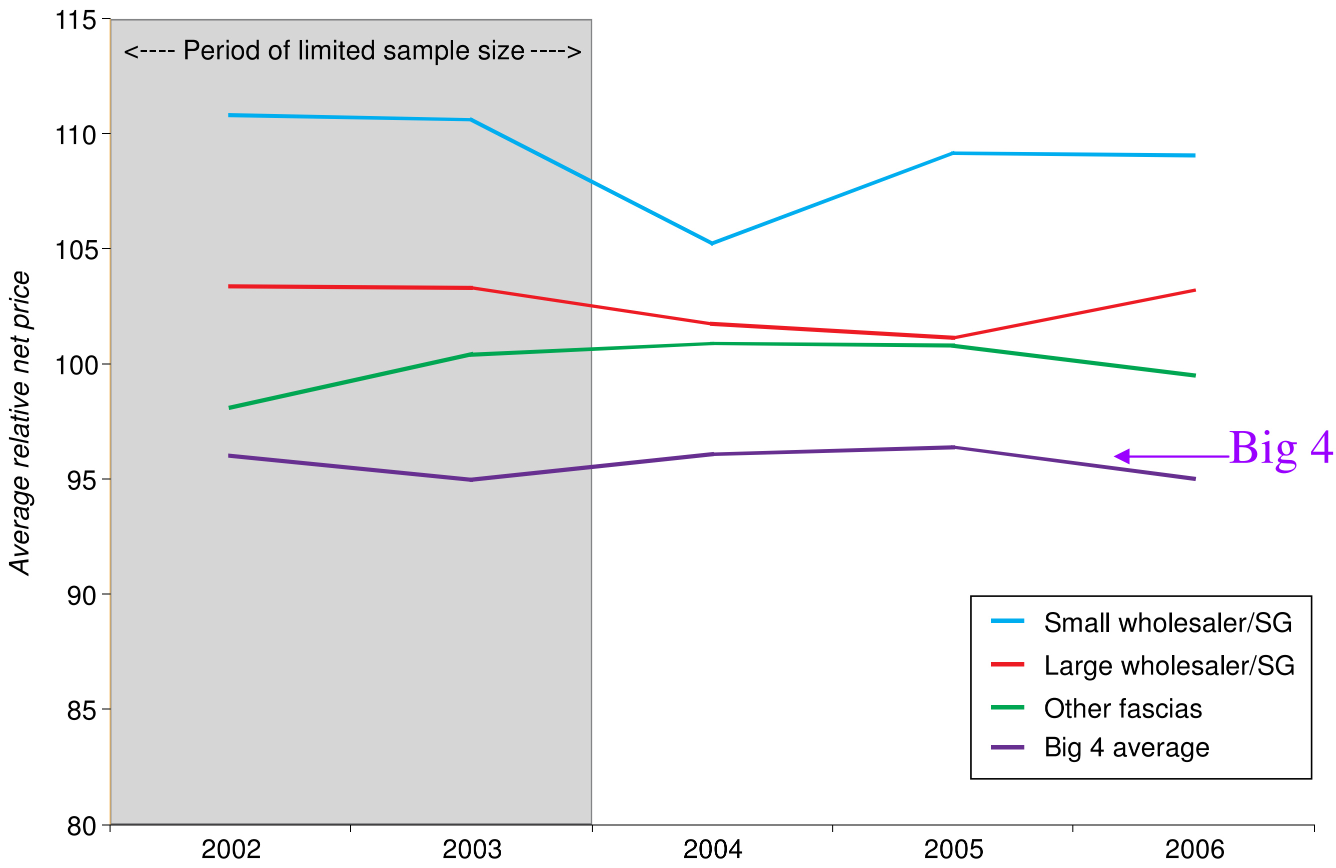
- a net price "which is net of all discounts, variable and fixed in nature",[24] as these can affect retailers' ability to compete on non-price dimensions. Variations in the sophistication of suppliers' accounting systems meant that there were fewer observations for unit price than there were for net price.

[21] Paragraph 1.13 of the ACS paper.
[22] Or, in an expanding market, less entry will occur than would otherwise have been the case.
[23] See paragraph 19 of Appendix 5.3 of the Final Report: www.competition-commission.gov.uk/rep_pub/reports/2008/fulltext/538_5_3.pdf.
[24] Ibid., paragraph 20.

Differences in suppliers' accounting systems meant that cost data were not sufficiently consistent across suppliers to allow for the generation of comparable margin data across SKUs. To compare customers across SKUs and across time, relative price and relative volume indexes were computed, i.e., relative to the average for all customers.

The results are reported in Figure 2 which presents the trends in average net supplier prices between 2002 and 2006, with retailers split into four groups. Average relative prices[25] were found to be 4 to 6 per cent lower for the four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco). There did not appear to be a significant widening in the differential between large retailers and other fascia and wholesaler/symbol groups during the period studied.

Figure 2: **Average net supplier price by grocery retailer**

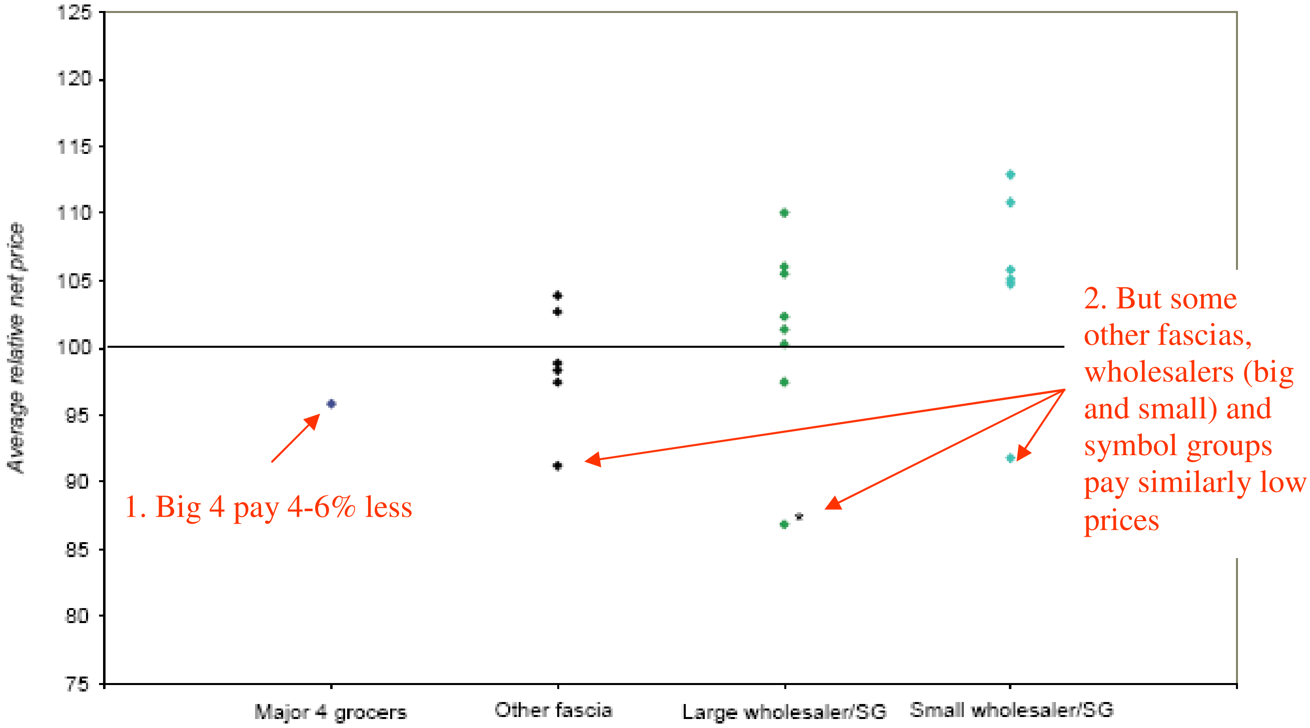



*Source*: Appendix 5.3, Figure 4(b): CC analysis of supplier information

Figure 3 presents a scatter plot of the three year average net supplier price paid by four types of retailers. It is clear that there is much variation in the data, with some other fascia, wholesalers and symbol groups paying similar prices to the 4 largest grocery retailers.

[25] Relative to the average price paid by all customers.

Figure 3: **Scatter plot of three-year average net price by customer**




*Source*: Appendix 5.3, Figure 2(b): CC analysis of supplier information

The CC conducted an econometric analysis of the relationship between supplier prices and SKU-level volumes to capture the effect of retailer size on suppler pricing. Ideally, such an analysis should control for non-size factors, such as distribution costs, cost of goods sold, retail offers and so on, but these data were not available. Instead, the CC took advantage of the panel nature of the data (i.e., for each supplier, there were price data by customer over several years) and, working on the assumption that these omitted variables are time-invariant, use a fixed-effects estimator to control for them. Here the 'fixed effect' is for each customer-product relationship.

Table 2 presents some representative results from the econometric analysis, where 'relvol' refers to the volume purchased relative to the average volume.

Table 2: **Regression output for different model specifications (linear and quadratic) – net price**

| *Specification* | *Variable* | *Coefficient* | *P-value* | *95% confidence interval* | |
|---|---|---|---|---|---|
| Linear* | relvol | –0.0372357 | 0.000 | –0.0518443 | –0.0226271 |
| | _cons | 103.7236 | 0.000 | 102.2271 | 105.22 |
| Quadratic* | relvol | –0.0688045 | 0.000 | –0.1022737 | –0.0353352 |
| | relvol2 | 0.0000755 | 0.024 | 9.85E-06 | 0.0001412 |
| | _cons | 105.4563 | 0.000 | 103.119 | 107.7937 |

*Source:* CC analysis of supplier information.

*Joint F test significant at the 1 per cent level.
*Note:* We report the results for both the linear and quadratic specifications for completeness.

Source: Appendix 5.3, Table 4

The results suggested a negative relationship between volume and supplier prices. For example, very small buyers (those purchasing 10 per cent of average volume) could expect to pay 3.4 per cent above the average price, whereas a very large buyer, those purchasing three times the average volume, could expect to pay 7.4 per cent below the average price. These results were significant at the 1 per cent level.

Taking primary brand goods[26] separately yielded weaker results. No relationship was found where unit price was used as the supplier price measure. Using net price, a much smaller differential between very large and very small buyers was found, compared to the results for the pooled data. One potential explanation for this is "that suppliers of primary brands are sufficiently strong to resist any countervailing buyer power that could be used to extract discounts. This may not be the case for non-primary brands because suppliers' bargaining power is weaker and therefore large customers' buyer power is then more effective …".[27]

A price differential between large retailers and smaller ones is a necessary but not sufficient condition for a waterbed effect. The CC did, therefore, find evidence of buyer power among large retailers, however, the CC rejected the theory that this was leading to a waterbed effect on the grounds that:

(i) There was no clear reduction in the number of convenience stores;

(ii) There was no clear widening in the average supplier price gap between largest and smallest retailer in recent years;

(iii) Some smaller buyers paid similar prices to the four largest retailers, suggesting that the sources of buyer power are clearly more complex that just 'scale', e.g., the ease of switching may mean smaller retailers have a great deal of bargaining power, while large retailers must switch large volumes.

(iv) Other factors may be driving price differences, e.g., distribution costs, cost of goods sold, retail offers, etc.

Had the CC found evidence for waterbed effects, it would then have needed evidence that the net impact of this movement was detrimental to consumers. Even if large grocery retailers were found to be capturing market share as a result of a waterbed effect, it could well be the case that consumers were better off due to the lower prices relative to convenience stores - driven by a combination of lower supplier prices and competition between large retailers. In the investigation, this issue was not pursued, as the CC did not consider that the circumstances described or implied by the ACS model of the waterbed effect were met in UK grocery retailing.[28]

### 4.2 Buyer power, contractual incompleteness and "ex-post hold up"

A second area of potential concern in relation to buyer power is that it can adversely affect suppliers' incentives to invest in new products, product improvements, advertising or brand-building. The problem of ex-post hold up arises where suppliers make investments that are profitable *ex ante*, but the exercise of buyer power by retailers to force down prices which are negotiated after the investment has already been made (*ex*

[26] In the report, the definition of primary brand goods was redacted so as to protect the confidentiality of the data source used, but Smith and Thanassoulis (2008) provide a useful general definition, unconnected to the data the CC used: "[p]rimary brands, such as Coca-Cola, enjoy a high level of brand recognition from consumers and therefore are considered must-stock items for most retailers."(p.2): Smith, H., and J. Thanassoulis (2008) "Bargaining between retailers and their suppliers", University of Oxford Department of Economics Discussion Paper Series, No.388, February.
[27] See paragraph 48 of Appendix 5.3.
[28] See paragraph 5.42 of the Final Report.

*post*) results in the sunk costs of the investment not being rewarded. As a result, suppliers' incentives to invest could be damaged and "hold up" of upstream investment and innovation occurs. Typical market-led solutions to this problem include vertical integration or long-term contracts (e.g., between a coal mine and an electricity generator[29]). However, retailers' and suppliers' ability to contract on a particular investment in a product is generally limited, as contracts between suppliers and retailers tend to be "incomplete".[30]

Retailer reputation could potentially play a role in solving the hold-up problem, or at least in mitigating its effects. If retailers' buyer power is such that hold-up is possible, both retailers and suppliers would value a retailer's reputation for not forcing prices to a level where suppliers' investment incentives are severely affected. It is in retailers' long-term interests that suppliers invest and innovate, but it can be the case that retailer's short-term incentives to compete with other retailers aggressively on price come to dominate these long-term interests in suppliers investing in product innovation, new product development, advertising, brand development and so on.

In the course of the CC's examination of supply chain issues, practices identified included:

(i) Lump sum payments from suppliers to retailers;

(ii) Retrospective price adjustments;

(iii) Retrospective financing of promotions;

(iv) Delays in payments to suppliers substantially beyond the agreed date;

(v) Requirement that suppliers make excessive payments to retailers in response to customer complaints; and

The CC's examined a number of pieces of evidence in relation to retailers' supply chain practices. These included:

- matters raised by both individual suppliers and suppliers' associations;
- the GfK supplier survey; and
- CC review of emails between two large grocery retailers (Asda and Tesco) and their suppliers.

Of the 380 concerns raised with the CC by suppliers and supplier associations, nearly half related to the transfer of excessive risks or unexpected costs from grocery retailers to suppliers, and one-third related to requirements for retrospective payments or other adjustments to previously agreed supply arrangements. Concerns expressed by suppliers regarding potential damage to their business prevented the CC from discussing details of individual complaints with the grocery retailers. This meant that the CC were unable to form a definitive view on each individual matter, but it nevertheless allowed for a general impression to be formed regarding the overall prevalence and relative extent of these practices.

[29] See Joskow, P.L. (1987) "Contract Duration and Relationship-specific Investment: Empirical Evidence from Coal Markets", *American Economic Review*, 77(1), March, pp.168-185. He provides empirical evidence that buyers and sellers make longer commitments to the terms of future trade at the contract execution stage, and rely less on repeated bargaining, when relationship-specific investments are more important.

[30] For a treatment of the theory of incomplete contracts, see, for example, Hart, O. (1995), *"Firms, Contracts, and Financial Structure",* Oxford: Oxford University Press.

The GfK supplier survey involved the collection of information from suppliers by means of interviews with 456 suppliers. This was based on a supplier population of 3,800 firms which had been constructed from lists of suppliers provided by 11 large grocery retailers. The sample was representative of the supplier population in terms of the main grocery product categories supplied. The survey collected information on a number of practices addressed under the SCOP that may lead to uncertainty for suppliers in relation to their future income. A summary of this evidence is presented in Table 3 (all figures are percentages) and indicated that a significant proportion of suppliers surveyed, between about a third and a half, experienced practices such as payment delays, excessive payments for customer complaints, and retrospective price adjustments. It is worth noting that these practices were less frequent where the four retailers covered by the SCOP were involved.

Table 3: **Suppliers reporting various practices carried out by grocery retailers in past five years**

| | *All grocery retailers* | *Four grocery retailers covered by the SCOP* | *Increased frequency over past 12 months* % |
|---|---|---|---|
| Delays in receiving payments from a grocery retailer substantially beyond the agreed time | 48 | 28 | 37 |
| Required to make excessive payments to grocery retailers for customer complaints | 48 | 36 | 40 |
| Additional services required in relation to packaging and distribution | 37 | 29 | 49 |
| Requested price reductions for products soon before or after delivery | 37 | 26 | 58 |

*Source:* GfK, *Research on suppliers to the UK grocery market, A report for the Competition Commission*, January 2007.

The CC reviewed over 100,000 emails between retailers Asda and Tesco, and their suppliers sent during June and July 2007, while the retailers were engaged in a price war. The CC review of this correspondence suggested that at least 20 of the 52 practices identified in the 2000 Supermarkets investigation continued to be practised. This email evidence suggested the application of intense pressure to suppliers to fund promotions, sometimes at very short notice as an area of potential concern in relation to competition and supply chain practices. Another area of possible concern was the supply of information by suppliers on competing grocery retailers' pricing, product ranges and promotions.

If the exercise of buyer power were to result in hold up then we might expect to observe evidence of innovation and investment in the supply chain suffering as a result. The evidence on product innovation that the CC reviewed included the new product database compiled by market research firm, Mintel, data from the Office of National Statistics and the Department of Trade and Industry on R&D expenditure by firms in the food and drink sector, two industry reports by economic consultancies on product innovation in the food and drink sector; results from the GfK supplier survey and data on the number of new products being sold by the four largest grocery retailers each year. The CC did not identify a declining trend in UK grocery suppliers' propensity to engage in product innovation. However, the problem with such a comparison is that we do not observe the level of investment that would have occurred in the absence of the supply chain practices. Thus, the report acknowledges that the level of investment and innovation might have been even higher in a well-functioning market.

The CC also assessed the profitability and financial viability of suppliers and the evidence did not indicate a systematic problem with the financial viability of food and drink manufacturers during the period surveyed. There was no ongoing decline in margins or return on capital for these companies. While margins for food and drink manufacturers may have been adversely affected by cost pressures, such as rising commodity prices, these cost increases appear, at least in part, to have been reflected in retail prices.[31]

For primary producers, the evidence the CC collected in relation to profitability proved complex, with some sectors, such as dairy, seeing significant exit in recent years, while farmgate prices and incomes have risen for those who remained in the sector. Looking at four key UK farming sectors—dairy, red meat, pig meat and fresh fruit— found that a variety of factors have influenced returns for farmers in recent years.[32] These include exchange rate variations, reform of the Common Agricultural Policy, food safety and animal health and welfare issues, regulatory arrangements for the sale and marketing of primary products, demand for UK agricultural produce from customers other than UK grocery retailers, as well as the ability of UK grocery retailers and intermediary purchasers of farm products to exert buyer power so as to extract lower prices from farmers. Nevertheless, the CC concluded that, if unchecked, the supply chain practices would ultimately cause harm to consumers.

### 4.3 Demand withholding

In theory, buyer power can manifest itself in the form of buyers strategically withholding demand, therefore, pushing down input prices. Doing so leads to lower quantities and higher downstream prices for consumers. There are number of assumptions that must hold for this to hold.[33] First, purchasing a higher quantity must push up the price. In other words, the supply curve must be upward sloping. Second, there is no scope for buyers to exert power by obtaining *individual* discounts, so there is a uniform trading price. These assumptions may be unlikely to hold in markets where bilateral bargaining is common and is likely to be found in markets with many small producers, e.g., competitive commodity markets or some food markets.

The CC looked for evidence of demand withholding in the market for fresh fruit, as this was seen as a market where this was possible. There were no specific allegations of this occurring and an analysis of the industry's cost structures, recent purchasing patterns and retail prices did not find any evidence that demand withholding was taking place.

### 4.4 Summary on buyer power

In summary, the CC found evidence of buyer power, contractual incompleteness and supply chain practices consistent with ex post hold up and poorly-aligned incentives. It did not find evidence of buyer power resulting in demand withholding and higher prices for consumers.

## 5. Remedies

During the first phase of a market investigation the CC identifies whether or not there are features that prevent, restrict or distort competition and so give rise to an "adverse effect on competition" (AEC). If the CC finds that there is an AEC, it must then consider measures to remedy, mitigate or prevent the AEC, or the resulting detrimental effects on consumers. CC remedies can be structural (e.g., in the BAA Airports investigation the CC intends to order BAA to divest three of its airports) or behavioural (e.g., in the Classified Directory Advertising Services (CDAS) market investigation the CC imposed a price control on the

[31] See Appendix 9.2 of the Final Report: www.competition-commission.gov.uk/rep_pub/reports/2008/fulltext/538_9_2.pdf.
[32] See Appendices 9.3 to 9.6 of the Final Report: www.competition-commission.gov.uk/rep_pub/reports/2008/538grocery.htm.

dominant firm). The remedies may be implemented by the CC itself through exercising its order-making powers or by accepting undertakings from the parties. Alternatively, or in addition, the CC may recommend that action should be taken by others, such as government, regulators and public authorities, e.g., in the rolling stock leasing market investigation, the CC recommended that the Department for Transport should make a number of changes to the way it awards rail passenger franchises. Recommendations do not bind on the organisation to whom they are addressed. Remedies can be a combination of action by the CC and a recommendation for action by others, as in Groceries.

Broadly speaking the remedies in the Groceries market investigation can be grouped into those which address horizontal issues and those which address vertical issues. The horizontal issues of barriers to entry and local market concentration were addressed through a number of different remedies. First, a group of remedies were aimed at limiting the use of restrictive covenants and exclusivity agreements by large grocery retailers ("Controlled Land" remedies). Second, a recommendation is to be made to the government that legislation be amended such that Land Agreements are no longer excluded from the provisions of the Competition Act 1998. Third, the CC would recommend that the government introduce a "Competition Test" as part of the planning system, when large grocery retail developments are proposed, to prevent the emergence or strengthening of highly concentrated local markets. The "Competition Test" recommendation is under review as a result of the Competition Appeal Tribunal (CAT) judgment following an appeal brought by Tesco.

The vertical issue to be addressed by the CC remedies was that of supply chain practices by grocery retailers which transfer excessive risk or unexpected costs to suppliers. The CC is seeking to remedy these problems through the introduction of the Groceries Supply Code of Practice (GSCOP), a strengthened version of the existing Supermarkets Code of Practice (SCOP), and through a recommendation to government for the establishment of an Ombudsman to monitor and enforce compliance.

### 5.1 Horizontal Remedies

Highly-concentrated local markets were found to be a feature of the groceries market which was detrimental to consumers and control of land by incumbent retailers through land bank sites, restrictive covenants, exclusivity arrangements, and land sites that are leased or subleased to third parties in highly-concentrated local markets were found to act as a barrier to entry, by limiting entrants' access to potential sites for new mid-sized and larger grocery stores.

The CC is in the process of implementing a number of remedies in relation to "controlled land", most of which will be implemented by the CC by means of its order-making powers.

(i) Large grocery retailers must lift the a number restrictive covenants (RCs) identified in the Report within 6 months;

(ii) Upon application to the OFT by the owner of the land burdened by an RC, the relevant large grocery retailers must release that RC if it is in a highly-concentrated local markets where the retailer has a strong local market position;

(iii) Large grocery retailers must not impose new RCs that may restrict grocery retailing or have equivalent effect;

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[33] See Inderst, R., and N. Mazzarotto (2008)"Buyer Power in Distribution" in the *ABA Antitrust Section Handbook, Issues in Competition Law and Policy, W.D. Collins (ed.), pp. 1953-1978.*

(iv) Large grocery retailers must not enforce/seek enforcement of the 30 exclusivity agreements (EAs) identified in the Final Report beyond 5 years after date of the Report;

(v) Large grocery retailers must not enforce/seek enforcement of existing EAs if they are in highly-concentrated local markets where the retailer has a strong local market position after 5 years from the Report or 5 years from the store opening, whichever is later;

(vi) Large grocery retailers must not enforce/seek enforcement of new EAs after 5 years from the store opening.

In relation to land agreements, the CC will be recommending that the government lift the Land Agreement Exclusion Order (LAEO) so that Exclusivity Agreements that restrict grocery retailing no longer benefit from exclusion from the provisions of Chapter I of the Competition Act 1998. The Chapter I prohibition prohibits agreements which may affect trade within the UK, and which have as their object or effect the prevention, restriction or distortion of competition within the UK. One reason for the granting of the Order was that restrictive agreements relating to land were thought unlikely to have an appreciable effect on competition, but the CC came to the view that these can act as barriers to entry and so have an adverse effect on competition. The Government is currently consulting on options for changes to this Order, with its currently preferred option being the repeal of the Order altogether.

The CC also proposed a recommendation that the government introduce a "Competition Test" as part of the planning process when large grocery retailers apply to build or extend a store. This remedy is aimed at preventing the emergence or strengthening of highly-concentrated local markets. The test would involve the Office of Fair Trading acting as a statutory consultee within the planning process. The test would apply to all applications for planning permission for grocery retail store development where the store is or will have a net sales area above 1,000 sq metres. Applications will ***pass*** the test if:

(a) that retailer is not present with a store of greater than 1,000 sq metres in the isochrone ('new entrant'); or

(b) there are 4 or more large grocery fascias in the isochrone already; or

(c) there are ≤3 large grocery retail fascia and that retailer post-development will have <60% of groceries sales area (for large groceries stores) in the isochrone.

There would be provision for local planning authorities to allow a development that 'fails' the test in 'exceptional circumstances'.

Following an appeal by Tesco, essentially against this proposed recommendation,, the Competition Appeal Tribunal quashed the CC's recommendation regarding the competition test remedy. The issue was remitted to the CC for further consideration and the CC is now needs re-assessing the economic costs and proportionality of the competition test remedy. This analysis involves considering in more detail how the competition test would change the structure of local markets and how these changes in market structure would affect grocery retailers' offers to consumers. The CC will then estimate the likely magnitude of costs and benefits to consumers of the Competition Test.[34] Until this issue is resolved, the implementation of the CC's 'horizontal' remedies is , obviously, "on hold".

[34] The CC has just issued its Provisional Decision in relation to the Groceries Remittal: www.competition-commission.org.uk/inquiries/ref2009/groceries_remittal/provisional_decision.htm.

**5.2 Vertical Remedies**

While the CC did not find that the financial viability of food and drink manufacturers was under immediate threat as a result of the exercise of buyer power by grocery retailers, it did conclude that the transfer of excessive risks or unexpected costs by grocery retailers to their suppliers was likely to lessen suppliers' incentives to invest in new capacity, products and production processes. It concluded that, if unchecked, these supply chain practices would ultimately have a detrimental effect on consumers.

The CC is in the process of introducing (by Order) the Groceries Supplier Code of Practice. This is a strengthened version of the existing Supermarkets Code of Practice, which was the result of an earlier CC investigation into supermarkets. The Code of Practice will apply to grocery retailers with annual turnover in excess of £1 billion and the provisions include:

(i) An overarching fair dealing provision;

(ii) A requirement that grocery retailers to keep written records of all agreements with suppliers on terms and conditions of supply;

(iii) A prohibition on retrospective changes to terms and conditions of supply;

(iv) A prohibition on suppliers' liability for shrinkage;

(v) A dispute resolution mechanism with binding arbitration and compensation/liquidated damages;[35] and

(vi) Provisions for a procedure for retailers de-listing (or significantly reducing volumes) from a supplier; and

(vii) A requirement that grocery retailers provide to the body monitoring and enforcing the GSCOP any information as it may reasonably require in pursuit of its functions, those functions to include the investigation of issues not the subject of the dispute, including complaints from primary producers

The CC's other supply chain remedy is to recommend to the Department for Business, Innovation and Skills the establishment of an Ombudsman to monitor and enforce compliance with the Groceries Supplier Code of Practice. The role would involve:

- Gathering information to monitor compliance and pro-actively investigating issues arising;
- Administering binding arbitration of disputes between suppliers and retailers under GSCOP; and
- Reporting to the Office of Fair Trading on the nature of complaints and disputes.

Despite extensive consultation, it is now clear that the major retailers will not voluntarily implement the establishment of the Ombudsman. In which case, the CC will recommend that Government legislate for this.

[35] The parties to a contract can agree what sum will be payable by way of damages (or how it will be calculated) in the event of a specified breach of contract. Provided that this is a genuine pre-estimate of loss that would be suffered as a result of that breach, this amount will be payable, without the claimant having to prove actual damage as a result of the breach of contract. This is known as liquidated damages.

Broadly, these supply chain remedies aim to lessen the extent to which grocery retailers can exercise their buyer power in a way that would adversely affect investment incentives and result in poorly-aligned incentives. Many of the provisions of the GSCOP could be seen as steps in making the contracts between suppliers and retailers more complete (e.g., ensuring that written records of contracts are kept and prohibiting retrospective changes to terms and conditions of supply) and so reducing the possibility for ex post hold up. It remains to be seen whether these measures can be made to work in practice.

## 6. Conclusions

The scale of the investigation meant that there was a very wide range of issues, and, hence, a wide range of evidence, for the CC to consider. The CC's Issues Statement[36] sought to focus the CC's attention on three specific questions (not unlike the "Theories of Harm" framework used in merger investigations). These were:

(a) "whether any aspect of the behaviour of grocery retailers towards their suppliers affects competition in any market;

(b) whether any aspect of the structure of any local market for groceries, or any aspect of the conduct of grocery retailers or consumers in the market for groceries (or in any other market in which grocery retailers operate) affects competition in one or more local markets for groceries, or in any other product market; and

(c) whether the operation of the planning regime as it affects grocery retailing, or any conduct by grocery retailers, including any aspect of the acquisition, disposal, development or use of land, affects competition in any market."[37]

In summary, the CC found evidence of:

(i) Horizontal market power and barriers to entry

(ii) Buyer power, but buyer power, *per se*, was not found to be a concern. However, buyer power combined with contractual incompleteness and ex post hold up were found to lead to the transfer of excessive risks or unexpected costs by retailers to their suppliers.

The CC's remedies powers are intended to be used to reduce barriers to entry, limit entry and expansion by retailers that already have a significant presence in highly-concentrated areas and remove potentially adverse incentives in the supply chain by making contracts more complete.

[36] See: www.competition-commission.gov.uk/inquiries/ref2006/grocery/pdf/issues_statement.pdf.

[37] Ibid., paragraph 8.