COMPETITION COMMISSION

The supply of groceries in the UK market investigation

30 April 2008

Website: www.competition-commission.org.uk

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The Competition Commission has excluded from this published version of the report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by ✂.

Market investigation into the supply of groceries in the UK

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Introduction

1. On 9 May 2006, the Office of Fair Trading (OFT) referred the supply of groceries by retailers in the UK to the Competition Commission (CC) for investigation under section 131 of the Enterprise Act 2002 (the Act). We published our Emerging Thinking, accompanied by eight working papers in January 2007. A further 18 working papers were published in the lead-up to the publication of provisional findings in October 2007, and we published our provisional decision on remedies in February 2008. This document, together with its appendices, constitutes our final report.

2. We found 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.

3. 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.

4. We are taking a number of steps to address the problems that we identified. We are recommending to Government and the devolved administrations that a competition test be applied, as part of the planning process, to proposed new stores (and proposed extensions to existing stores). The competition test will favour new entrants and grocery retailers other than those which already have a significant local market share. We will also require grocery retailers to relinquish control over landsites in highly-concentrated markets that we have identified as inhibiting entry by competing retailers. Further, we will be limiting the ability of grocery retailers to prevent land being used by their competitors in the future.

5. We will be tightening the provisions of the Supermarkets Code of Practice and broadening its application such that more grocery retailers will be required to abide by its terms. We will also be seeking legally binding commitments from grocery retailers to establish an Ombudsman to oversee the revised Code. If we cannot secure suitable undertakings from these grocery retailers, we recommend that Government takes the necessary steps to facilitate the establishment of the Ombudsman.

6. The competitive position of convenience stores relative to large grocery retailers was a key concern for many in our investigation. We received a considerable body of evidence from the Association of Convenience Stores (ACS) and others showing that the competitive pressure on convenience store operators is intense. 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.

7. We assessed whether there are structural aspects of the market or industry practices that may facilitate collusion or coordination between grocery retailers. In light of the OFT's recent actions in relation to collusive behaviour involving grocery retailers, we note that consolidation among suppliers to grocery retailers and practices such as category management could facilitate the exchange of information between grocery retailers through their suppliers. We did not uncover compelling evidence of effective tacit coordination over a wide range of products. This does not, of course, rule out the existence of attempts at collusion, which the OFT has responsibility for investigating.

8. Many parties raised the strong market position of Tesco as a matter of concern. We did not find there to be competition concerns that apply to Tesco over and above those that apply to other grocery retailers. There would obviously be cause for concern if any one retailer were able to achieve and exploit significant market power to the detriment of consumers. Our assessment is 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.

9. A range of issues outside the competition arena were put to us during this investigation. These include the impact of grocery retailing on the nation's health, the social impact of low-priced alcohol sales, the importance of high streets and rural shops to social cohesion, the future of UK farming and self-sufficiency in food, working conditions at grocery suppliers in the developing world, and the environmental impact of grocery retailing. These concerns provide important context and background to the investigation but they are not, in themselves, competition issues. We are restricted by statute from making findings in relation to non-competition matters. Many of the broader issues that were raised with us are already under active consideration and review by those government departments and agencies with policy and operational responsibilities in these areas.

10. In conducting this investigation we received more than 100 submissions from grocery retailers, and more than 600 submissions from suppliers, consumers, local authorities and others. We held approximately 80 hearings in England, Scotland, Wales and Northern Ireland with grocery retailers and others, conducted numerous site visits and held round-table discussions with food and drink manufacturers, primary producers and academics to discuss issues arising in the investigation. We supplemented the evidence collected through submissions and hearings with data from questionnaires, surveys commissioned by the CC and industry publications. Much of this evidence is published on our website. Where necessary, we used our legal powers to ensure that the information required for our investigation was provided to us.

11. The following paragraphs summarize our detailed findings.

Market definition

12. The definition of the market for grocery retailing provides a framework within which we can assess how competition works. 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 (ie 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 (ie all stores larger than 280 sq metres); and

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

13. 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.

14. 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.

15. 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.

16. 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.

Potential distortions in competition between grocery retailers

17. We found that large grocery retailers, particularly the four largest grocery retailers and especially Tesco, generally obtain lower prices from suppliers than wholesalers. We concluded that these differences in supplier prices in themselves do not give rise to an adverse effect on competition (AEC). Further, we did not find evidence that lower supplier prices for the four largest grocery retailers resulted in higher supplier prices for other grocery retailers and wholesalers. (That is, we did not find a 'water-bed effect' to be operating in UK grocery retailing.)

18. We concluded that the current and projected financial performance of the grocery wholesaling sector did not support a finding that the financial viability of the sector was threatened. Further, to the extent that convenience store closures placed grocery wholesalers under financial pressure, we expect that this would first be addressed through industry consolidation rather than leading to a 'tipping point' in the financial viability of the entire sector.

19. We did not find that the pattern of below-cost selling by large grocery retailers represented behaviour that was predatory in relation to other grocery retailers and did not find that it was likely to have unintended consequences that would represent an AEC. Further, we did not find that below-cost selling was likely to mislead consumers in relation to the overall cost of shopping at a particular grocery store. We found that temporary promotions on some products, including fuel, to attract consumers and increase total sales (commonly referred to as 'loss leading') may represent effective competition between retailers and may benefit consumers by reducing the average price for a basket of products.

20. We found that the local vouchering activities of most grocery retailers were not extensive. Competition concerns have only been raised with us in the context of the vouchering activities of one grocery retailer, Tesco. We did not find that these activities were predatory or would otherwise have an AEC. Similarly, we did not find that the fuel price discount vouchering of large grocery retailers had an AEC. In our view, vouchering campaigns, in the absence of predatory behaviour, represent effective competition between retailers that benefits consumers by reducing their shopping bills.

21. We found that Sainsbury's and Tesco's expansion in convenience store retailing was likely to have been supported in large part by their existing advantages in terms of brand reputations, low purchasing prices and distribution networks. We did not find their expansion in this sector to be anti-competitive, and to the extent that it has resulted in increased competition, consumers will have benefited. Further, we did not find that Sainsbury's and Tesco's expansion in convenience store retailing 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.

Concentration in local markets for grocery retailing

22. We found that between 11 and 27 per cent of larger grocery stores, and between 10 and 22 per cent of mid-sized and larger grocery stores are in highly-concentrated local markets. In contrast, few convenience stores face weak local competition.

23. We concluded that consumers are adversely affected by local markets being highly concentrated rather than more competitive. Weak competition in local markets allows a grocery retailer to worsen the store-specific retail offer at its stores in those markets and earn higher profit margins at those stores. We estimated that the effect of weak local competition on store-level profit margins allows large grocery retailers to earn an additional £105–£125 million in profits per year at their larger grocery stores. This represents around 3 per cent of annual profits for the four largest grocery retailers. The additional store-level profits at mid-sized grocery stores as a result of weak local competition may be of a similar order.

24. We also concluded that a grocery retailer with a number of stores in highly-concentrated local markets can weaken that part of its retail offer, such as pricing, that it applies uniformly, or near uniformly, across its stores nationally and thereby earn higher profits across all of its stores. The scale of the impact on national price

levels arising from weak local competition, while difficult to measure, is potentially very substantial. For example, for each 0.1 per cent increase in national price levels (ie each 1p increase on a £10 shopping basket), consumer expenditure on groceries at the four largest grocery retailers increases by £80 million a year.

Barriers to entry and expansion in grocery retailing

25. The pattern of retailer entry and expansion in recent years provides an indication of the presence and nature of barriers to entry and expansion. We found that the vast majority of new larger grocery stores had been opened by existing large grocery retailers and a significant proportion of the existing stores of these retailers had been extended. We did not observe other grocery retailers opening larger grocery stores in significant numbers. Our analysis also indicated that highly-concentrated local markets tended to persist rather than attract new entry.

26. Two possible cost advantages for large grocery retailers that might act as a barrier to entry are distribution costs and purchasing costs. We found that large grocery retailers' purchasing cost advantages were likely to be of much greater significance than their distribution cost advantages since purchasing costs make up a substantial proportion of grocery retailers' total cost base. Tesco has a significant advantage in purchasing terms over other large grocery retailers and wholesalers. Asda, Morrisons and Sainsbury's also have a purchasing terms advantage relative to other large grocery retailers and wholesalers, but to a lesser extent than Tesco. Small wholesalers have the highest purchasing costs.

27. In our view, convenience store operators that purchase from small wholesalers could, in many cases, address at least some of their purchasing cost disadvantage by shifting to a larger wholesaler. Further, small wholesalers have the potential to address at least some of their cost disadvantage relative to other wholesalers and grocery retailers by joining a larger buying group. As a result, we concluded that convenience stores do not face a barrier to entry arising from any cost disadvantage relative to other grocery retailers.

28. We concluded that the presence of the grocery wholesaling sector mitigated any cost disadvantages for regional grocery retailers and new entrants. We recognized that Tesco had a purchasing cost advantage over other grocery retailers. However, we did not find that this currently represents an insurmountable barrier to entry or expansion by other large grocery retailers. We continue to observe the expansion of these other large grocery retailers, and our analysis showed that, subject to some year-on-year variations, Tesco's advantage in purchasing terms had not grown since 2003 despite its increase in total sales and market share. As a result, we did not find Tesco's purchasing cost advantage to have an AEC.

29. We found that the planning system, in pursuing the broad-based objectives for which it is intended, necessarily constrained the development of new larger grocery stores, but placed more limited constraints on entry by mid-sized grocery stores and convenience stores as well as extensions to existing larger grocery stores. Securing planning permission for a new larger grocery store takes a significant amount of time in terms of site assembly and the planning process. We found that the costs associated with these activities, together with the risk of permission not being granted, represented a more significant barrier to entry for other grocery retailers and new entrants than for existing large grocery retailers.

30. The shortage of land available for new larger grocery stores, arising in part from the planning system, meant that the control of this land by grocery retailers in certain highly-concentrated local markets frustrates new entry that would strengthen

competition. We did not find that grocery retailers were engaging in holding undeveloped land (landbanking) as a strategy to impede the entry by rival grocery retailers into local markets. However, we found 90 'controlled landsites', that is, sites which grocery retailers had prevented from being used for grocery retailing that each act as a barrier to entry in a highly-concentrated local market and have an AEC.

31. In terms of the three major product markets that we identified, we concluded that:

- for larger grocery stores, an AEC arises from the planning system, which necessarily constrains overall entry and also acts in favour of the existing large grocery retailers, and controlled landsites, which act as a barrier to entry in a number of highly-concentrated local markets;

- for mid-sized and larger grocery stores, an AEC arises from controlled landsites, which act as a barrier to entry in a number of highly-concentrated local markets; and

- for all grocery stores, limited barriers to entry or expansion mean that we have not identified an AEC.

Coordination between grocery retailers

32. The structure of UK competition enforcement involves a division of functions between the CC and the OFT in relation to coordination. The OFT is responsible for enforcing the provisions of the Competition Act 1998 and Article 81 of the EC Treaty in relation to collusion. The CC investigates tacit coordination, where relevant, in the context of market investigations that are referred to it. To the extent that a market investigation reveals any specific evidence of collusion, we will pass that evidence to the OFT for further investigation, and will respond appropriately to any requests from the OFT for information in our possession.

33. In relation to collusion, we are aware of a number of structural factors and behavioural practices in grocery retailing that may facilitate collusion and note the OFT's recent actions in this area.

34. We found that the conditions necessary for tacit coordination to arise and be sustainable may be present in UK grocery retailing. However, it may be that sustaining coordinated conduct over thousands of differentiated products or choosing a smaller group of products on which to coordinate would be sufficiently complex to prevent the emergence of tacit coordination. Further, we have not seen evidence of large grocery retailers engaging in parallel behaviour with respect to the prices. As a result, we did not find that grocery retailers were engaged in tacit coordination. However, we are concerned that, given the structure of the grocery retailing market, such behaviour could occur in the future.

Competition issues in the groceries supply chain

35. We concluded that, based on the size of grocery retailers, wholesalers and buying groups relative to suppliers, together with the evidence on supplier pricing and margins, all large grocery retailers, wholesalers and buying groups have buyer power in relation to at least some of their suppliers. However, we found that the buyer power of even the largest grocery retailers may be offset by the market power possessed by suppliers of the most prominent branded goods.

36. Grocery retailers' buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices. We did not find that the financial viability of food and drink manufacturers was under threat as a result of the exercise of buyer power by grocery retailers. However, the transfer of excessive risks or unexpected costs by grocery retailers to their suppliers is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. We concluded that, if unchecked, these practices would ultimately have a detrimental effect on consumers.

37. We concluded that the principal manner in which excessive risks or unexpected costs could be transferred from grocery retailers to suppliers was through retailers making retrospective adjustments to the terms of supply. We also concluded that there were circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier was excessive. We also have concerns regarding the transfer of risk from grocery retailers to suppliers where, as a result, the retailer has less incentive to minimize that risk.

38. While the evidence that we reviewed did not indicate that there had been a declining trend in UK grocery suppliers' product innovation over recent years, it was difficult to draw conclusions given the different influences on investment and innovation. We expect that the investment and innovation performance that we observed in the groceries supply chain would have been even better in the absence of the practices that we observe. Further, the SCOP appeared to be constraining the exercise of buyer power by the four largest grocery retailers to some extent, and its removal would allow these grocery retailers to exercise their buyer power in a way that would further transfer excessive risks and unexpected costs to suppliers. We were also concerned with the levels of investment and innovation that might be realized in the future were the supply chain practices that we observed to continue.

Features which prevent, restrict or distort competition

39. We found that a combination of one or more of the following features prevent, restrict or distort competition in certain local markets for the supply of groceries by larger grocery stores:

(a) A significant number of local markets have high levels of concentration, and these high levels of concentration have in many cases persisted over a number of years.

(b) The planning regime and its application by Local Planning Authorities (LPAs) in accordance with the policy objectives of the planning regime necessarily act as a barrier to entry or expansion in a significant number of local markets:

(i) by limiting construction of new larger grocery stores; and

(ii) by imposing costs and risks on smaller retailers and entrants without pre-existing grocery retail operations in the UK that are not borne to the same extent by existing large grocery retailers.

(c) The control of land in highly-concentrated local markets by incumbent retailers acts as a barrier to entry, by limiting entrants' access to potential sites for new larger grocery stores.

40. We found that a combination of one or more of the following features prevent, restrict or distort competition in certain local markets for the supply of groceries by mid-sized and larger grocery stores:

(a) a significant number of local markets have high levels of concentration, and these high levels of concentration have persisted over a number of years; and

(b) the control of land in highly-concentrated local markets by incumbent retailers acts as a barrier to entry, by limiting entrants' access to potential sites for new mid-sized and larger grocery stores.

41. We found that the exercise of buyer power by certain grocery retailers with respect to their suppliers of groceries, through the adoption of supply chain practices that transfer excessive risks and unexpected costs to those suppliers, was a feature of the markets for the supply of groceries by all grocery stores, which prevents, restricts or distorts competition in connection with the acquisition of groceries by large grocery retailers and some wholesalers and buying groups.

Remedies

42. To address the AEC we have found in relation to highly-concentrated local markets and barriers to entry we decided to implement the following remedies:

(a) Large grocery retailers will be required to release the 30 existing restrictive covenants in highly-concentrated local markets that we identified.

(b) Large grocery retailers with a strong local market position in a highly-concentrated local market (as identified in this report) will be required to release any existing restrictive covenants, beyond those identified in this report, in those local markets which may restrict grocery retailing or which have equivalent effect, which the owner of the burdened land has notified to the OFT and which the OFT has said exists in a highly-concentrated local market.

(c) Large grocery retailers will be prohibited from imposing new restrictive covenants that may restrict grocery retailing or which have equivalent effect. As an anti-avoidance mechanism, large grocery retailers must not enter into contractual arrangements which may restrict grocery retailing or which have equivalent effect, including, but not limited to, clauses in leases. We have decided to allow two limited exceptions to this:

(i) restrictions in leases to tenants of residential dwellings which specify that a leasehold property is to be used only for residential purposes; and

(ii) user clauses in leases setting out the specific purpose for which land is to be used and which mirror planning obligations.

(d) Large grocery retailers will be required not to enforce or seek the enforcement of any of the 30 existing exclusivity arrangements that have been identified in this report beyond a period of five years from the date of this report.

(e) Large grocery retailers will be required not to enforce or seek the enforcement of any existing exclusivity arrangements beyond those identified in this report after the longer of (i) five years from the date of this report, or (ii) five years from the date the grocery store was opened, where that arrangement relates to land in a highly-concentrated local market where it has a strong local market position and which may restrict grocery retailing or have equivalent effect.

(f) Large grocery retailers will be required not to enforce or seek the enforcement of new exclusivity arrangements once a period of five years from the opening of the grocery store to which the arrangement relates has elapsed.

(g) Grocery retailers will be required to provide to the OFT on request accurate figures for the groceries sales area of any store in the UK, and any other information that the OFT may require for the application of the competition test (see paragraph 43).

(h) Large grocery retailers will be required to notify to the OFT all acquisitions of existing grocery stores of more than 1,000 sq metres in net sales area.

43. In addition to the above remedies, which we will implement directly, we recommend that the following measures be put in place in order to address the AEC we found in respect of highly-concentrated local markets and barriers to entry:

(a) The Department of Communities and Local Government (CLG), the Scottish Executive, the Welsh Assembly Government and the Northern Ireland Executive should take the necessary steps to make the OFT a statutory consultee to LPAs on all applications for planning permission, whether submitted by a grocery retailer or a third party, for a development of a grocery retail store (including new stores and extensions) where that store has, or after the proposed scheme has been implemented will have, a net sales area in excess of 1,000 sq metres.

(b) The OFT, as a statutory consultee, should provide advice to the LPA on whether a particular retailer has passed or failed the competition test. Applications would pass the test if within a 10-minute drive-time of the developed store (as calculated according to readily available software):

(i) the grocery retailer that would operate the store was a new entrant in the local area; or

(ii) the total number of fascias (including any of the full-range national or regional grocery retailers and symbol groups) operating larger grocery retail stores in the local area were four or more; or

(iii) the total number of fascias were three or fewer and the grocery retailer operating the developed store would operate less than 60 per cent of groceries sales area (including the new or extended store).

44. In addition to the above measures to address the AEC we have found in respect of highly-concentrated local markets and barriers to entry, we also recommend to the Department for Business, Enterprise and Regulatory Reform (BERR) that it amend the Land Agreements Exclusion Order so that exclusivity arrangements which restrict grocery retailing and which are entered into by grocery retailers which were previously within its scope should no longer benefit from exclusion from the Competition Act 1998.

45. We further recommend to LPAs that they do not enter into any exclusivity arrangements in the future that may restrict grocery retailing or which have equivalent effect for a period of more than five years after the opening of the grocery retail store. We also recommend to LPAs that if they receive applications for the lifting of existing restrictions they have regard to any adverse effects on competition from those restrictions in reaching their decision.

46. To address the AEC that we found in relation to supply chain practices we decided to implement remedies establishing a Groceries Supply Code of Practice (GSCOP), based on the existing Supermarkets Code of Practice (SCOP), but amended such that:

(a) All grocery retailers with groceries turnover in excess of £1 billion a year are included within its scope.

(b) An overarching fair-dealing provision is included.

(c) Grocery retailers are prohibited from making retrospective adjustments to terms and conditions of supply.

(d) Grocery retailers are prohibited from entering into arrangements with suppliers that result in suppliers being held liable for losses due to shrinkage.

(e) Grocery retailers are required to enter into binding arbitration to resolve any dispute with a supplier arising under the GSCOP.

(f) Grocery retailers are required to keep written records of all agreements with suppliers on terms and conditions of supply.

(g) Grocery retailers are required to 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 dispute, including complaints from primary producers.

47. In addition to the above remedies, we will seek undertakings from grocery retailers to establish a GSCOP Ombudsman to monitor and enforce compliance with the GSCOP, and whose functions are to include:

(a) the gathering of information and proactive investigation of retailers' records in areas subject to complaint in order to identify whether breaches of the GSCOP have occurred;

(b) the publication of guidance on specific provisions of the GSCOP where it considers that differences of interpretation exist; and

(c) the publication of an annual report on the operation of the GSCOP.

48. We do not seek any role for the GSCOP Ombudsman that goes beyond that necessary to monitor and enforce the GSCOP, and will ensure that the responsibilities and functions of the GSCOP Ombudsman do not inadvertently facilitate collusion or coordination between grocery retailers and suppliers. We envisage that the GSCOP Ombudsman would prioritize the resources of its office to focus on those disputes and complaints concerning suppliers without market power over and above those concerning suppliers of major branded products that have market power.

49. In addition, we recommend to BERR that if we do not obtain satisfactory undertakings from the retailers creating the GSCOP Ombudsman within a reasonable period, it should take the necessary steps to establish the Ombudsman. We further recommend that, if this is the case, BERR should take steps to give the Ombudsman the power to levy significant financial penalties on the retailers for non-compliance.

50. If neither we nor BERR are successful in establishing the Ombudsman within a reasonable period of time, the functions of the Ombudsman will be carried out by the OFT, with arbitration of disputes under the GSCOP conducted by an independent body with expertise in dispute resolution, such as the Centre for Effective Dispute Resolution (CEDR).

51. Although our terms of reference do not permit us to make any finding in this regard, and we are therefore unable to make a formal recommendation, we suggest that, if it

subsequently appears that, despite the operation of the GSCOP (and the Ombudsman), intermediaries continue to transfer excessive risk and unexpected cost further up the supply chain, Defra and BERR should consider the introduction of appropriate measures, including the extension of the GSCOP and the role of the Ombudsman or the introduction of a similar, complementary code and arrangements to cover the intermediaries and primary producers.

52. We are aware that the operational environment for the groceries sector is likely to be entering a new phase as increasing commodity prices feed through into higher food prices in UK grocery stores. We consider that effective competition between grocery retailers is the best way to ensure that the effect on consumers of these cost, and ultimately price, increases is minimized. In framing our remedies, we were mindful of this new operating environment, and we consider our remedies to be appropriate. In relation to our supply chain remedies, changes in the operational environment may affect the relative bargaining position of grocery retailers and their suppliers. We wish to ensure that grocery retailers are able to negotiate the best possible price from their suppliers, while guarding against those actions by grocery retailers that will ultimately impose costs on consumers through harming investment or innovation in the supply chain. We will take all these factors into account in pursuing the implementation of our supply chain remedies and we expect that if it becomes necessary for BERR to implement the GSCOP Ombudsman it will take a similar view.

53. These findings represent the unanimous view of the Group of members responsible for this report with the exception of two members who favour a lower threshold than 60 per cent of groceries sales area for the purpose of the competition test (see paragraph 43), and one member who was not in favour of the establishment of a GSCOP Ombudsman.

Findings

1. Introduction

1.1. On 9 May 2006, the OFT referred the supply of groceries by retailers in the UK to the CC for investigation under section 131 of the Act.[1] This document, together with its appendices, constitutes our final report.

1.2. Our inquiry is a market investigation under the Act. Section 134(1) of the Act requires us to decide whether 'any feature, or combination of features, of each relevant market[2] 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'. If there is such a feature or combination of features, there is said to be an 'adverse effect on competition'.[3]

1.3. If the CC decides that there is an AEC, it is required (under section 134(4) of the Act) to decide whether action should be taken by it, or whether it should recommend the taking of action by others, for the purpose of remedying, mitigating or preventing the AEC or any detrimental effect on customers[4] that has resulted from, or may be expected to result from, the AEC; and, if so, what action should be taken.

1.4. This section provides an overview of the conduct of the investigation (see paragraphs 1.5 to 1.11), and the structure of the remainder of this report (see paragraphs 1.12 and 1.13).

Conduct of the investigation

1.5. Throughout our investigation, we have been concerned to ensure that, as in other CC investigations, our processes are both thorough and fair. In this respect, we have, of course, had regard to the CC's published guidelines on market investigations[5] and other published guidance.

1.6. During the investigation, we received around 100 submissions from the main parties,[6] including main submissions, responses to Emerging Thinking, comments on working papers published by the CC, responses to provisional findings, responses to our Notice of Possible Remedies and responses to our provisional decision on remedies. We received more than 600 submissions from third parties, including suppliers, supplier organizations, consumers, local authorities, government departments and others. Write-in campaigns were also organized by a number of parties, including Action Aid, Friends of the Earth, Tesco and Tescopoly. We held approximately 80 hearings with main and third parties, including hearings in Scotland, Wales

[1]The terms of reference for our investigation are provided in Appendix 1.1.
[2]A 'relevant market' is defined in section 134(3) of the Act as a market in the UK for goods or services of a description specified in the reference concerned.
[3]Under section 131(2) of the Act, a 'feature' of a market may refer to: *(a)* the structure of the market concerned or any aspect of that structure; *(b)* any conduct (whether or not in the market concerned) of one or more than one person who supplies or acquires goods or services in the market concerned; or *(c)* any conduct relating to the market concerned of customers of any person who supplies or acquires goods or services.
[4]A detrimental effect on customers is defined in section 134(5) of the Act as taking the form of: *(a)* high prices, lower quality or less choice of goods or services in any market in the UK (whether or not the market to which the feature or features concerned relate); or *(b)* less innovation in relation to such goods or services.
[5]*Market Investigation References: Competition Commission Guidelines*, *CC3*, June 2003, available on the CC website.
[6]The main parties to this investigation are Aldi Stores Limited, the ACS, EH Booth & Co Ltd, CGL, Costcutter, Iceland Foods Ltd, Lidl UK GmbH, Marks and Spencer plc, Morrisons, Musgrave (UK) Limited, Netto Foodstores Ltd, Nisa-Today's (Holdings) Ltd, Palmer & Harvey McLane Limited, Pareto Retail Ltd, The Proudfoot Group Ltd, Sainsbury's, Somerfield Stores Ltd, Spar (UK) Limited, Tesco and Waitrose Limited. We refer to other parties to this investigation as third parties.

and Northern Ireland, and held round-table discussions with food and drink manufacturers, primary producers and academic economists on different aspects of our investigation. We conducted site visits to grocery retailers and wholesalers as well as to a number of development sites and towns where local grocery retailing issues had been brought to our attention.

1.7. We supplemented the evidence and information gained from submissions and hearings by collecting substantial quantities of information through various questionnaires. These included a substantial questionnaire, consisting of more than 100 questions, that was sent to the main parties in the early stages of the investigation, as well as other questionnaires administered during the investigation covering issues such as the prices charged to grocery retailers and wholesalers by their suppliers. This information has helped us to construct a dataset of more than 14,000 UK grocery stores covering more than 30 variables, such as ownership, location, revenue, costs, sales area, product range, prices and store amenities.[1]

1.8. We also made use of a variety of industry publications and data sources. These include publications by market research organizations such as IGD and Verdict, and survey data collected by TNS and the Office for National Statistics (ONS). We have also undertaken separate surveys of suppliers to grocery retailers,[2] LPAs,[3] and the retail offer of grocery stores in 44 locations across the UK.[4]

1.9. We have, at various stages, published our thinking on a range of issues to assist parties in understanding our concerns, to elicit reactions and to aid transparency generally. We published an Issues Statement in June 2006, and our Emerging Thinking in January 2007. This was accompanied by eight working papers on different aspects of the investigation. A further 18 working papers were published in the lead-up to the provisional findings report in October 2007, and we published our provisional decision on remedies in February 2008.

1.10. Our policy has been to publish working papers in full as a basis for discussion and debate, but to excise material from these papers that may damage the interests of a party. (The Act requires us to have regard to the need to exclude from disclosure any information whose disclosure might significantly harm legitimate commercial or individual interests.) Subject to this proviso, we have sought throughout the investigation to make the process as transparent as possible by publishing the material we have issued and received. In this way, we aim to stimulate open discussion and debate of the issues.

1.11. In addition to publishing our thinking at key stages of the investigation, we also published evidence submitted by main and third parties, including non-confidential versions of parties' written submissions and responses to our publications, reports from the survey-based research that we commissioned. The full list of published material is in Appendix 1.2.

Report overview

1.12. This report sets out our decisions on the statutory questions that we have to answer under section 134 of the Act (see paragraph 1.2). It takes account of all the evidence received during the investigation. It refers, where appropriate, to material published

[1]Much of the store-level data collected from grocery retailers relates to June 2006. We have, where necessary, taken this into account in our analysis and made allowances for subsequent changes.
[2]GfK, *Research on suppliers to the UK grocery market: A report for the Competition Commission*, January 2007.
[3]CC, *Results from the Local Planning Authority survey on retail planning issues*, April 2007.
[4]GfK, *Groceries Inquiry—Local Case Studies*, June 2007.

separately on the CC website. Parties studying the report may want to refer to this separately published material. The report, however, is designed to provide or direct the reader to all material necessary to understand our decisions.

1.13. The remainder of this report is set out as follows:

- Section 2 sets out the context for this investigation, including the events leading up to the reference and some of the broader policy issues surrounding grocery retailing;

- Section 3 describes grocery retailing in the UK, including grocery retailers, wholesalers and suppliers, trends in grocery prices, and consumer behaviour;

- Section 4 considers the relevant product and geographic markets for the supply of groceries so as to inform our assessment of competition between grocery retailers;

- Section 5 assesses potential distortions in competition between grocery retailers;

- Section 6 discusses extent and effect of local market concentration in grocery retailing;

- Section 7 assesses barriers to entry or expansion in grocery retailing;

- Section 8 considers coordination between grocery retailers;

- Section 9 considers competition issues in the supply chain for grocery retailers;

- Section 10 summarizes our findings and identifies those features that we consider prevent, restrict or distort competition; and

- Section 11 sets out our assessment and decisions in relation to remedies.

2. Context for the investigation

2.1 This section sets out the broader context for our investigation into grocery retailing by:

- first, outlining the events leading up to the reference (see paragraphs 2.2 to 2.10);

- second, identifying some of the broader issues surrounding grocery retailing that have been brought to our attention and their relationship to our investigation (see paragraphs 2.11 to 2.18); and

- finally, reviewing recent competition-related developments in grocery retailing in other countries (see paragraphs 2.19 to 2.28).

Events leading up to this investigation

2.2 The CC conducted three inquiries in the grocery retailing sector in the eight years prior to this investigation. The first investigation in 1999/2000 (the 2000 investigation) was a broad-based investigation into grocery retailing similar to the present one but conducted under the monopoly provisions of the Fair Trading Act 1973, while the second and third inquiries were more limited investigations into specific merger transactions, namely the acquisition of Safeway (the Safeway inquiry) and

Somerfield's acquisition of around 100 stores from Morrisons (the Somerfield inquiry).[1]

2.3 The 2000 investigation had its origin in criticisms of the prices and profits of UK grocery retailers during the late 1990s, and in particular, a perception that the prices of many consumer goods, not just groceries, were higher in the UK than in comparable EU countries and the USA. Against this background, the OFT launched a study of the then four largest grocery retailers (Asda, Safeway, Sainsbury's and Tesco) in June 1998. This, in turn, led to a reference in April 1999 to the CC by the Director General of Fair Trading.

2.4 The 2000 investigation was carried out under a statutory framework different from the one that currently applies to CC market investigations. Previously, the CC was required to report to the Secretary of State on whether a monopoly situation existed, and if so, whether it operated against the public interest.[2] The CC concluded in the 2000 investigation that certain practices carried out by supermarkets gave rise to a complex monopoly situation, and found that two groups of these practices operated against the public interest.

2.5 The first group of practices found to be operating against the public interest concerned the pricing behaviour of a number of grocery retailers. The CC found that persistent selling of some products below cost distorted competition and damaged smaller grocery retailers and convenience stores, thereby adversely affecting elderly and less mobile consumers, who tended to rely on stores operated by smaller retailers. The CC also found that the practice of varying prices in different geographic locations, where such variation was not related to costs (known as 'price flexing'), operated against the public interest. This was because customers tended to pay more for groceries at stores that did not face particular competitors than they would have if those competitors had been present. The CC did not, however, recommend remedial action for this first group of practices.[3]

2.6 The second group of practices found to be operating against the public interest related to the behaviour of five grocery retailers towards their suppliers. This led to the establishment of the SCOP, which now regulates the conduct of the four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco) with respect to their suppliers.[4]

2.7 Following the 2000 investigation, the OFT continued to look at a range of matters related to grocery retailing. This included oversight of the SCOP (including a review of the SCOP in 2004 and an audit of retailers' compliance with the SCOP published in 2005—see paragraph 2.9), competition assessments of various mergers, including the Safeway and Somerfield transactions (see paragraph 2.2) as well as other

[1]More specifically, these were the proposed acquisition of Safeway in 2003 by each of Asda, Morrisons, Sainsbury's and Tesco (the Safeway inquiry), and, Somerfield's acquisition of a number of stores divested by Morrisons in 2005 (the Somerfield inquiry). The acquisition by Tesco of a CGL grocery store in Slough was also referred to the CC in 2007 (the Tesco Slough inquiry). The CC's inquiry into this acquisition was undertaken concurrently with this market investigation. Copies of the CC reports arising from the Safeway, Somerfield and Tesco Slough inquiries and the 2000 investigation can be found on the CC's website at www.competition-commission.org.uk.

[2]The public interest test contained in the Fair Trading Act stands in contrast to the market investigation regime in the Enterprise Act, which is focused exclusively on competition.

[3]Under the Fair Trading Act, where the CC considered that a monopoly situation operated against the public interest, it was required to consider what action should be taken to overcome the adverse effects and could make recommendations to the Secretary of State, but did not have the power to implement remedies directly.

[4]The CC's complex monopoly finding related to practices carried out by Asda, Safeway, Sainsbury's, Somerfield and Tesco. The CC decided that these practices only operated against the public interest when carried out by parties with a national share of grocery sales of more than 8 per cent. Somerfield was later found to have less than an 8 per cent share and did not become a signatory to the SCOP. Safeway was subsequently acquired by Morrisons, and Morrisons since that date has agreed to be bound by the SCOP as if it were a signatory.

mergers not referred to the CC, such as Tesco's acquisitions of T&S Stores in 2002 and Adminstores in 2004. A list of the OFT's most recent decisions in the grocery retailing sector is provided in Appendix 2.1.

2.8 In carrying out its responsibilities the OFT continued to receive complaints and representations about grocery retailing. In some cases, these related to competition matters, such as the operation of the SCOP, the pressures facing convenience stores, and the market position of Tesco relative to other grocery retailers, while in other cases the concerns raised with the OFT related to matters lying outside the OFT's remit. (These concerns, covering both competition and non-competition matters, have been put to us in this investigation also—see paragraphs 2.11 to 2.18 in relation to non-competition matters.)

2.9 In 2005, in response to continuing concerns about the effectiveness of the SCOP, the OFT commissioned and published the results of a compliance audit.[1] In addition to inviting parties to present evidence related to the SCOP audit, the OFT also invited evidence on whether there were aspects of the supply of groceries by grocery retailers that adversely affected competition. The OFT initially decided that there were no grounds for a market investigation reference to the CC. However, following a challenge to this decision in the Competition Appeal Tribunal by the ACS and Friends of the Earth, the OFT withdrew its decision. After further investigation the OFT made a reference to the CC, which is the basis of our current investigation.

2.10 In its reference decision, the OFT found that there were several features of the market for the supply of groceries by retailers in the UK that could reasonably be suspected to be preventing, restricting or distorting competition. It was concerned that:

(a) the planning system could restrict or distort competition by raising the cost of, and also limiting the scope for, entry, particularly by way of new large format stores;

(b) the land holdings of large grocery retailers and their use of restrictive covenants could be used to reinforce their existing market position in some local areas and this could have an anti-competitive effect;

(c) there was evidence to suggest that the buyer power of the major grocery retailers had increased since 2000 and that the differential between suppliers' prices to large grocery retailers compared with those for wholesalers and buying groups had increased, and that this increase in buyer power could harm consumer choice by undermining the viability of alternative business models, including wholesale distribution to the convenience store sector; and

(d) aspects of the major grocery retailers' pricing policies—below-cost selling and 'price flexing'—could distort competition, although the extent of the possible distortion was unclear.

We considered each of these matters during this investigation.

Competition and other public policy issues concerning grocery retailing

2.11 As we set out in paragraph 2.8, in the lead up to this investigation a broad range of concerns were raised with the OFT, some of which related to competition, and others that related to broader public policy issues. These concerns have continued to be

[1]OFT, *Supermarkets: The code of practice and other competition issues*, OFT783, March 2005.

expressed by parties in submissions to our investigation. However, because of our statutory remit, our investigation can only cover one aspect of the public policy issues concerning grocery retailing, namely the effectiveness of competition between grocery retailers.

2.12 The broader public policy issues concerning grocery retailing raised with us during this investigation include the social cohesion of urban and rural communities, the character of UK high streets, the social and health consequences of alcohol sales by grocery retailers, the impact of grocery retailing on the nation's health, the environmental impact of the groceries supply chain, working conditions among agricultural workers both in the UK and abroad, and the security of UK food supplies and the sustainability of the supply base.

- In relation to local communities, the New Economic Foundation (NEF) and others[1] said that we should protect the consumer interest by considering the planning system's protection of the local environment and the contribution made by small shops, the environmental and local economic benefits of local distinctiveness and community benefits of 'social glue'. Further, the Rural Shops Alliance raised concerns about the expansion in the number of larger grocery stores and the potential loss of village stores.

- In relation to the character of high streets, it was argued by Friends of the Earth, the ACS and others that the demise of convenience stores and specialist grocery stores as a result of the expansion and activities of large grocery retailers was having a detrimental effect on the composition and character of high streets and, in consequence, damaging consumer choice.

- In relation to alcohol sales, it was argued by the Royal College of Physicians and others that the widespread availability of cheap alcoholic drinks in grocery stores was encouraging an increase in alcohol consumption, including so-called binge drinking and consumption by those under the legal age limit, leading in turn to violence, disorder and loss of social cohesion.

- In relation to the impact of grocery retailing on the nation's health, the Food Poverty Project said that a reduction in the choice of grocery stores was limiting customers', and particularly disadvantaged customers', choice of healthy food options. It said that contributing factors included the predominance of processed food in grocery outlets, particularly convenience stores owned by large grocery retailers.

- In relation to the environmental impact of the groceries supply chain, Farmers' Link said that grocery retailers' visual requirements for the presentation of fresh produce resulted in waste and increased pesticide use, and that this in turn has adverse environmental impacts. It also noted the costs associated with food packaging and the environmental impact of food transport, including the import of food products from distant locations.

- In relation to working conditions among agricultural workers, particularly those employed to pick and pack fruit, vegetables and shell fish, the Gangmasters Licensing Authority raised specific issues in relation to the UK, and ActionAid, Banana Link, Women Working Worldwide, Traidcraft, Oxfam and other bodies raised more general issues in relation to workers in developing countries.

[1]A full list of those giving evidence to the investigation is in Appendix 1.2.

- There were also wider issues raised by the National Federation of Women's Institutes in relation to the security of UK food supplies and by the National Farmers Union as to the sustainability of the current UK groceries supply base.

2.13 There are limits as to how far these issues can be addressed in the context of our investigation. An effective competition policy makes a key contribution to the broader economy with a positive impact on economic growth, innovation and living standards. The benefits to consumers include lower prices, better product quality, greater choice and more innovation. In the case of grocery retailing, we are required to identify and, where appropriate, correct any adverse effects on competition or resulting detrimental effects on consumers. We considered the issues outlined in paragraph 2.12 and the related evidence with great care and looked carefully at their relevance to the competition issues that we are required to address. However, it is not within the CC's statutory powers to address these wider issues in their own right. These wider matters are for the relevant government agencies or departments.

2.14 The Government, recognizing the wide range and often inter-linked nature of many of the broader public policy issues surrounding grocery retailing and the groceries supply chain, recently asked the Cabinet Office Strategy Unit to undertake a study of food and food policy. The project is examining trends in the production and consumption of food, key drivers in those trends and the implications for the wider economy, society and the environment. It is also looking at the opportunities and challenges facing the food system, including issues such as public health, food safety, changing consumer tastes and preferences, and environmental sustainability. The Cabinet Office published the first part of its report in January 2008, setting out a number of areas where the current debate on food may need to be refocused.[1] The final report, which will set out the Strategy Unit's conclusions and recommendations to Government, is expected in spring 2008.

2.15 We also note that the Sustainable Development Commission (SDC)[2] published a review of the Government's role in supporting sustainable food in grocery stores in February 2008. The review identified what the SDC sees as six priority areas for action by Government and grocery retailers, namely: waste, nutrition and obesity, climate change, fair supply chains,[3] ecosystems and water. The report makes a number of recommendations in each of these areas.

2.16 A competition investigation can, and should, take note of the broader public policy issues that are addressed in the Cabinet Office and SDC reports discussed above. Indeed, we can, and must, take account of the wider context in which our decisions are made, and the implications that purely competition-based outcomes and solutions may have for other policies. But where different policy imperatives point in different directions—for example, where the promotion of competition in retailing has adverse consequences in terms of other policies—the critical and sensitive balancing judgment that has to be made is a matter for Government, rather than for us.

2.17 Bearing these considerations in mind, our overall aim has been to decide whether the interests of UK consumers are well served by grocery retailers, whether competition is effective and whether it will remain so. We describe our statutory duties in relation to customers and consumers in Appendix 2.2. In terms of customer detriment, the Act directs us to consider price, quality, choice and innovation. In the context of grocery retailing, choice can mean the choice of product range within store as well as

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[1]The Cabinet Office, *Food: An analysis of the issues*, January 2008.
[2]The SDC is an independent advisory body to the Government on sustainable development.
[3]We consider the groceries supply chain from a competition perspective in Section 9.

the choice between fascias; we considered both and we did not, as some parties advocated, examine price effects alone.

2.18 In our view, consumers themselves are in the best position to judge when and where to shop and will exercise their choice accordingly. Effective competition in grocery retailing offers the best guarantee that consumers will have a choice of grocery stores and retailers. We do not seek to impose on consumers a particular view of what the 'retail offer' should be or to tell them which stores or types of stores they should use. Instead we seek, so far as possible, to make sure that the market can operate and adapt freely in accordance with consumer behaviour and preferences as they develop.

International competition-related developments in grocery retailing

2.19 The UK is not alone in wishing to ensure that competition in grocery retailing is effective. Competition authorities in a number of other countries have also recently taken steps to ensure that competition in grocery retailing is strengthened and consumers are well served by an industry that accounts for a significant proportion of weekly household expenditure. We provide below a brief overview of measures being taken in certain other countries in areas such as below-cost selling, the groceries supply chain, and coordination between grocery retailers, to put our investigation in a broader international context.

2.20 In the Republic of Ireland, below-cost selling of most grocery products at a retail level was prohibited until 2006 under the Restrictive Practices (Groceries) Order.[1] A review in 2005 found that the Order was causing food prices to increase at a faster rate than would otherwise be the case.[2] As a result, the Order was repealed. A subsequent report by the Irish Competition Authority of changes in food prices since the repeal found that the Order had been contributing to higher food prices in Ireland.[3] (We consider below-cost selling in the UK in paragraphs 5.52 to 5.69.)

2.21 In France, below-cost selling by grocery retailers, in most cases, continues to be prohibited[4] and suppliers are required to supply goods at the same price to any grocery retailer or to be able to justify any discriminatory practice (eg in terms of sales volumes or specific marketing services). As was the case in Ireland prior to the repeal of the Groceries Order, there are concerns in France that the prohibition of below-cost selling, which does not allow retailers to pass on to consumers a large proportion of the rebates and commercial services paid to them by suppliers, is contributing to higher food prices than would otherwise be the case.[5] There are also concerns that the combination of a prohibition on below-cost selling and the

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[1] *Restrictive Practices (Groceries) Order, 1987.* The order prohibited the sale of groceries below invoice price, with some exceptions in the area of fresh produce, and the payment of listing fees by suppliers.

[2] *Restrictive Practices (Groceries) Order 1987—A Review and Report of Public Consultation Process*, Consumer Strategy Group, Department of Enterprise, Trade and Employment, 2005.

[3] Prior to the repeal of the Order, the Irish Competition Authority found that when there was a general increase in grocery prices, the price of grocery products regulated by the Order had tended to increase more rapidly than other items, and when the general grocery price level was falling, the prices of unregulated grocery products tended to fall more rapidly than other items. During the nine-month period following the removal of the Order, the Irish Competition Authority found that price trends changed, so that the price of grocery items that were previously regulated under the Order fell, even while the price of other items rose. However, since the beginning of 2007, prices of products that were regulated under the Order and those that were not appear to have increased with broadly similar trends. (See, also, Irish Competition Authority, *Grocery Monitor Report 1*, April 2008.)

[4] Below-cost selling continues to be regulated in a number of other EU member states, including Belgium, Germany, Greece, Italy and Spain.

[5] The Rapport Attali concluded that the ban on below-cost selling led supermarkets to negotiate back-margins (ie discounts) that were not passed on to consumers. The ban led to a lessening of competition between the grocery retail chains and between suppliers. As a result, prices went up significantly. Between 1996 and 2004, in France the price index for food items (excluding meat and fresh produce) increased by 16 per cent, 3 percentage points more than the general price index. Between 1998 and 2003, the price index for food items (excluding meat and fresh produce) grew faster in France than in the rest of the Euro zone.

regulation of supplier terms has the potential to encourage coordination between retailers and suppliers.[1] The *Loi Chatel*, adopted in January 2008, now allows retailers to subtract the value of all rebates and commercial services from the invoice price, which has had the effect of lowering the threshold below which below-cost selling is prohibited. A lifting of the per se ban on discriminatory practices in vertical relationships is also anticipated in the near future (ie the requirement that suppliers, in effect, charge the same price to all customers). (We consider possible coordination between grocery retailers in the UK in Section 8.) More generally, in its recent report, the Attali Commission recommended the abolition of the law prohibiting below-cost selling of groceries.[2]

2.22 The opening of new grocery stores larger than 300 sq metres in France is regulated at the local level under the *Loi Raffarin*. The original aim of the measure was to protect small shops from the growth of large retailers. However, a review of these measures by both the French Competition Council and the Attali Commission concluded that some relaxation, or even the complete repeal, of this law would be appropriate, given its apparent effect in creating barriers to entry for new retailing and reducing the extent of competition between incumbent firms.[3] (We consider planning-based restrictions on new grocery stores in the UK in paragraphs 7.34 to 7.68.)

2.23 The Bundeskartellamt (BKA) in Germany has conducted a number of investigations into the exploitation of buyer power by grocery retailers under the German Competition Law (GWB). An amendment to the GWB in 1999 allows the BKA to initiate proceedings based on complaints without having to identify the individual complainant. The BKA believes that this has been helpful in encouraging complainants to come forward, and in recent years the BKA has been able to remedy a number of cases informally without having to issue a decision. This is often preferable for suppliers that wish to continue their business relationship with the retailer. In several cases, the BKA closed proceedings after the retailers concerned agreed to stop pressuring their suppliers to pass on to them certain refunds granted to their suppliers by other firms. The BKA, however, believes that the 1999 amendment has its limits in that if an informal solution cannot be found, the BKA has to issue a formal decision, and in this case, the identity of the complainant needs to be revealed. It should be noted that the BKA may also initiate and pursue investigations into the exploitation of buyer power without a complaint from an individual buyer. (We consider suppliers' concerns regarding their ability to bring complaints in the context of the UK Supermarkets Code of Practice in paragraph 9.57.)

2.24 Relations between grocery retailers and their suppliers are a matter of concern at the European level. A written declaration of the European Parliament, signed by 439 MEPs and adopted in February 2007, raised concerns regarding grocery retailers abusing their buying power to force down prices paid to suppliers. The declaration calls upon the Directorate-General of Competition of the European Commission (DG Comp) 'to investigate the impacts that concentration of the EU supermarket sector is having on small businesses, suppliers, workers and consumers and, in particular, to assess any abuses of buying power which may follow from such concentration'. At the time of publication of our final report, DG Comp's response was still in preparation.

[1]In a recent decision, the French Competition Authority found that anticompetitive vertical agreements between five toy suppliers and their distributors (retailers) resulted in retail price maintenance. This was facilitated by the regulation of supply terms which resulted in transparent wholesale and retail prices and made monitoring and detecting deviations easier.
[2]*Rapport de la Commission pour la liberation de la croissance française*, pp144–148.
[3]Ibid.

2.25 In Norway, the Norwegian Competition Authority in 2007 considered intervening in grocery retailers' exchange of weekly price information through the marketing information company ACNielsen that provided detailed information on each retailer's prices within a given geographic area. The Norwegian Competition Authority considered that this reduced uncertainty in the market and contributed to suppressing competition between grocery retailers. The grocery retailers and ACNielsen subsequently chose to cease circulation of these reports.[1] We consider coordination in grocery retailing in Section 8.

2.26 In Australia, the Australian Competition and Consumer Commission (ACCC) was asked by the Federal Government in January 2008 to report on the competitiveness of retail prices for groceries in the light of evidence of high concentration and increasing prices for groceries. (Concentration in local markets for grocery retailing in the UK is discussed in Section 6.)

2.27 Finally, mergers between grocery retailers continue to attract the attention of competition authorities worldwide. In New Zealand, the proposed acquisition of the Warehouse Group by either Foodstuffs or Woolworths is the subject of a case in the New Zealand Court of Appeal, after the New Zealand High Court overturned the New Zealand Commerce Commission's decision not to clear the transactions. In the USA, a merger between Wholefoods and WildOats was unsuccessfully opposed by the Federal Trade Commission and is presently the subject of appeal proceedings. The objections of the respective competition authorities in these cases are based, in part, on the effect of the transactions in local markets, and on the barriers to entry to grocery retailing created by scarcity of suitable sites and/or planning controls. (We consider local market concentration in UK grocery retailing in Section 6 and barriers to entry in Section 7.)

2.28 We expect grocery retailing, given its importance to consumers, to continue to be of significant interest to competition authorities and trust that this report will contribute to the understanding of this industry and the relevance of the UK experience to other countries.

3. Grocery retailing in the UK

3.1 This section provides an overview of UK grocery retailing and, in doing so, gives background and context for our assessment of the effectiveness of competition in this industry. The section is set out as follows:

- first, we describe the current structure of the UK grocery retail sector (see paragraphs 3.2 to 3.29);
- second, we describe the structure of the supply chain for grocery retailing (see paragraphs 3.30 to 3.38);
- third, we examine retail prices for groceries, trends in the product range of large grocery retailers, the extent of grocery store choice for consumers and consumer satisfaction with grocery retailing (see paragraphs 3.39 to 3.46); and

[1]The Swedish Competition Authority (SCA) similarly investigated the use of the ACNielsen information exchange between retailers in Sweden in 2007 but found no grounds to intervene. The SCA found that the information was aggregated in such a way that retailers could not readily identify actual sales or price information for competitor stores. The SCA also noted that competition in the groceries market largely takes place at local level, with local stores having a significant influence over price setting, and that these factors limit how the ACNielsen information can be used.

- finally, we review consumer shopping habits, particularly shopping frequency (see paragraphs 3.47 to 3.57).

Structure of the UK grocery retail sector

3.2 In 2007, an estimated £110.4 billion of grocery sales were made through nearly 100,000 grocery stores in the UK.[1] In the following paragraphs we categorize the different grocery retailers and stores through which these sales were made. We also describe the structure of grocery wholesaling in the UK, and set out differences in grocery retailing in Northern Ireland compared with Great Britain.

Categories of grocery retailer

3.3 There are seven major categories of grocery retailer in the UK:

- *Large grocery retailers* have operations throughout Great Britain and, in some cases, Northern Ireland. These retailers carry a full-range of grocery products and have an integrated grocery wholesaling function that purchases directly from grocery suppliers. Large grocery retailers may operate stores in multiple store size categories (see paragraph 3.7). There are currently eight large grocery retailers in the UK, namely Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. We collectively refer to Asda, Morrisons, Sainsbury's and Tesco as the four largest grocery retailers. (See Appendix 3.1 for further detail on these large grocery retailers.)

- *Regional grocery retailers* operate in a particular part of the UK, operate mid-sized and/or larger grocery stores and may also operate convenience stores. Regional grocery retailers carry a full-range of grocery products and generally use grocery wholesalers to source supplies or use buying groups to negotiate on their behalf with suppliers. Regional grocery retailers include Booths in north-east England, Dunnes in Northern Ireland, Proudfoot in Lincolnshire and Yorkhire and the regional Co-ops, such as Co-op Midlands and Co-op East of England.[2]

- *Symbol group retailers* operate stores under a common fascia (or symbol). Stores within a symbol group may be independently owned and use the common fascia under a franchise or membership agreement, or alternatively, may be directly owned by the symbol group or affiliated wholesalers. Symbol group retailers generally source supplies through affiliated wholesalers. The central organization of the symbol group undertakes joint marketing and advertising, coordinates promotions, arranges for the provision of own-label products using the symbol group brand, and supplies support services (eg staff training, financial management and merchandising). Symbol group retailers in the UK include Spar, Premier, Londis and Costcutter.

- *Convenience store operators* are all operators of convenience stores (see paragraph 3.10). They include large grocery retailers, regional grocery retailers, symbol group retailers, and independent non-affiliated convenience store operators.

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[1]IGD, *UK Grocery Outlook*, September 2007. Total sales excludes non-grocery and tobacco sales. This figure most closely matches the definition of groceries provided in the OFT's reference to us.
[2]Other regional grocery retailers include Long's Supermarket (11 stores), Roys (eight stores), Harry Tuffins (six stores) and CK's Supermarkets (18 stores).

- *Limited Assortment Discounters* (LADs) carry a limited range of grocery products and base their retail offer on selling these products at very competitive prices. The three major LADs in the UK are Aldi, Lidl and Netto.[1] Each of Aldi, Lidl and Netto carries in the region of 1,000 to 1,400 product lines in stores ranging from 500 to 1,400 sq metres. (Stores of a similar size operated by a large grocery retailer generally carry around 5,000 products.) Aldi, in large part, carries only own-label goods, while both Lidl and Netto carry larger volumes of branded products. In 2006, Aldi, Lidl and Netto had around 1,000 stores.[2] (See Appendix 3.1 for further detail on these retailers.)

- *Frozen food retailers* specialize in the sale of frozen foods and generally carry a limited range of other grocery products. Frozen food retailers in the UK include Iceland (690 stores) and Farmfoods (approximately 300 stores).[3] (See Appendix 3.1 for further detail on Iceland.)

- *Specialist grocery retailers* primarily sell an individual grocery product category and include bakeries, butchers, fishmongers, greengrocers, health food shops and off-licences. In 2007, there were approximately 8,000 off-licences, 7,100 butchers, 6,500 bakeries, 3,600 greengrocers, and 1,300 fishmongers in the UK.[4]

3.4 In 2007, large grocery retailers accounted for an estimated 85 per cent[5] of total grocery sales with the four largest grocery retailers accounting for just over 65 per cent of total grocery sales. Since 2002, the share of national grocery sales by large grocery retailers has grown. Tesco and Morrisons, in particular, have increased their share of national sales significantly (see Figure 3.1). The LADs have also grown their share of national grocery sales by a small amount over this period.[6]

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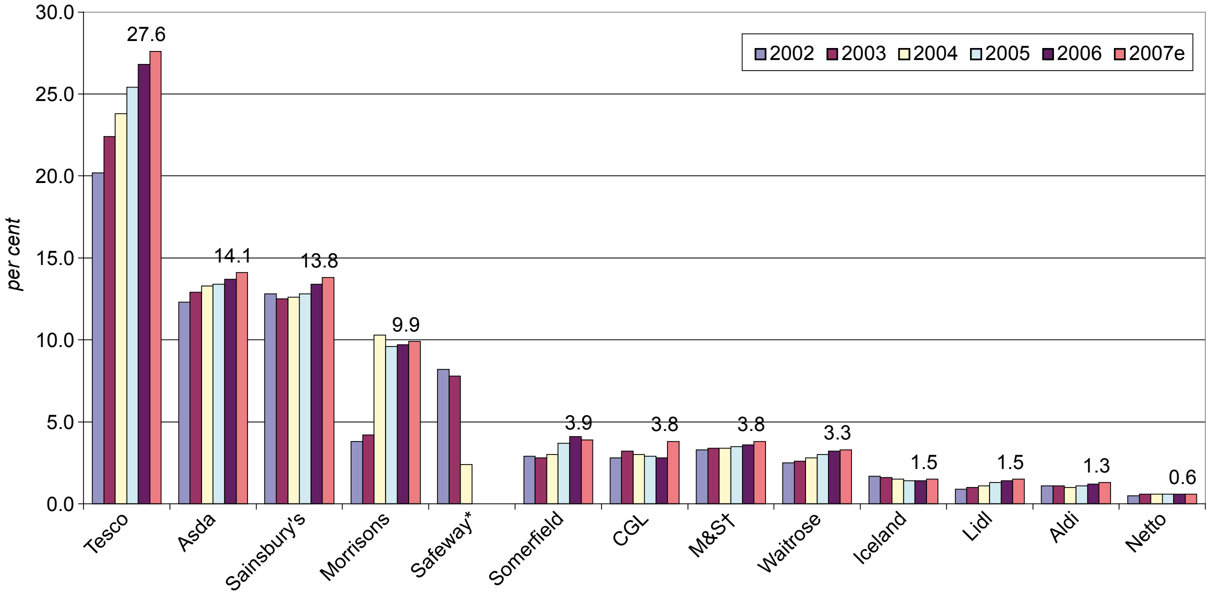
[1]Another LAD retailer in the UK is Home Bargains, owned by TJ Morris Ltd, which has approximately 140 stores across the UK and sells a range of discounted brand name products, including groceries.
[2]Verdict, *UK Grocery Retailers*, 2008.
[3]Other frozen food retailers include Heron Frozen Foods, Frozen Value and Cook.
[4]ONS, *UK Business: Activity, Size and Location* 2007.
[5]Verdict, *UK Grocery Retailers,* 2008, p44. (The measurement of national sales shares differs between market researchers, such as Verdict and IGD, due to differing definitions of grocery retailers and product categories. For example, Verdict estimated the value of sales made by UK grocery retailers (including grocery and non-grocery products) to be £118.2 billion in 2007, while IGD estimated total sales by grocery retailers in 2007 at £133.3 billion. Trends in sales shares for large grocery retailers are, however, consistent across both Verdict and IGD.)
[6]We also note that, in addition to the seven major categories of grocery retailer that we identify in paragraph 3.3, there is one specialist Internet-based grocery retailer in the UK, Ocado. Ocado, which has a supply agreement with Waitrose, commenced trading in January 2002.

FIGURE 3.1

National sales shares by grocery retailer, 2001 to 2007



Source: Verdict, *UK Grocery Retailers 2008*, February 2008.
*Safeway was purchased by Morrisons in 2004.
†M&S sales relate to grocery only.

Categories of grocery store

3.5 In addition to the seven categories of grocery retailer identified in paragraph 3.3, there are six major categories of grocery store. These are larger grocery stores, mid-sized grocery stores, convenience stores, LADs stores, frozen food stores and specialist grocery stores.

3.6 In the following paragraphs we define larger, mid-sized and convenience stores and set out the categories of grocery retailer that operate each of these different types of grocery store. (We set out the reasons for using these store size thresholds in paragraphs 4.20 to 4.63.) LADs stores, frozen food stores and specialist grocery stores are operated by LADs, frozen food retailers and specialist grocery retailers respectively.

3.7 *Larger grocery stores* are full-range grocery stores larger than 1,000 to 2,000 sq metres.[1] An estimated 90 to 95 per cent of all larger grocery stores in the UK are operated by eight large grocery retailers (Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose). The remaining larger grocery stores in the UK are operated by symbol groups, such as Costcutter, Nisa-Today's and Spar, regional grocery retailers, such as Booths, Dunnes, Proudfoot and the regional Co-ops, and may also include a small number of independent stores not affiliated to any symbol group.

[1]Store sizes can be measured in terms of gross internal area, net sales area or groceries sales area. For the purposes of our analysis, groceries sales area is the most appropriate measure. However, it can be difficult to obtain accurate data on groceries sales and costs or groceries sales area, and as a result, in some cases we have used data on net sales area. For stores smaller than 1,000 sq metres, there is little difference between net sales area and groceries sales area. However, for stores larger than 1,000 sq metres this difference does become larger. Where we think that this difference will affect the results of our empirical analyses we have adjusted the data accordingly. For example, we have excluded stores larger than 6,000 sq metres from the margin concentration analysis on the basis that they probably derive a large share of their revenue from the sale of non-grocery products.

3.8 The number of stores operated by each of these large grocery retailers that is greater than 1,000 sq metres, 1,400 sq metres and 2,000 sq metres is set out in Table 3.1.[1] The number of larger grocery stores operated by a number of these retailers varies considerably according to the threshold used as the lower bound for defining a larger grocery store. For example, Somerfield owns 258 stores larger than 1,000 sq metres, which represents around 11 per cent of stores larger than 1,000 sq metres. However, it owns less than 1 per cent of all stores larger than 2,000 sq metres.

TABLE 3.1 **Large grocery retailers operating larger grocery stores**

Grocery retailer	*No of stores larger than 1,000 sq metres*		*No of stores larger than 1,400 sq metres*		*No of stores larger than 2,000 sq metres*	
	Number	*Proportion of all the retailer's stores %*	*Number*	*Proportion of all the retailer's stores %*	*Number*	*Proportion of all the retailer's stores %*
Asda	303	99	302	99	293	96
CGL	90	5	40	2	11	1
M&S	88	21	41	10	4	1
Morrisons	371	100	357	96	273	74
Sainsbury's	452	60	400	53	340	45
Somerfield	258	23	73	7	10	1
Tesco	615	32	534	28	424	22
Waitrose	163	90	105	58	41	19
Total	2,346		1,853		1,396	

Source: CC.

Note: Based on store numbers as at July 2006.

3.9 *Mid-sized grocery stores* are full-range grocery stores between 280 sq metres and 1,000 to 2,000 sq metres. Three large retailers, Somerfield (569 stores), CGL (395 stores) and M&S (289 stores) operate the greatest number of mid-sized stores (see Table 3.2). Each of these grocery retailers also operate significant numbers of larger grocery stores, particularly within the 1,000–1,400 sq metres range (see Table 3.1). The regional Co-ops (262 stores) also collectively operate a substantial number of mid-sized stores as do a number of symbol groups, such as Budgens, Costcutter, Nisa-Today's and Spar.

[1]We use these three thresholds as we decided that the appropriate store-size threshold for larger grocery stores is 1,000 to 2,000 sq metres (see paragraph 4.135), while we use a 1,400 sq metre threshold for the purposes of much of our analysis (see paragraph 4.138).

TABLE 3.2 **Operators of mid-sized grocery stores**

Grocery retailer	*No of stores 280–1,000 sq m*	
	Number	*Proportion of all the retailer's stores %*
Asda	3	1
Booths	10	38
Budgens	95	52
Costcutter	29	2
CGL	395	65
Regional Co-op	262	27
M&S	289	68
Morrisons	0	0
Nisa-Today's	44	96
Proudfoot	2	40
Sainsbury's	40	5
Somerfield	569	51
Spar	52	2
Tesco	113	8
Waitrose	16	9
Total	1,919	

Source: CC.

Note: Based on store numbers as at July 2006. CGL includes United Co-operatives Limited. The data in this table, while extensive, is not a comprehensive record of all grocery stores larger than 280 sq metres in the UK. We are aware of the presence of a number of independent grocery retailers for which we have not been able to collect store-level data.

3.10 *Convenience stores* are grocery stores smaller than 280 sq metres that sell a range of groceries (ie non-specialist retailers). As we set out in paragraph 3.4, convenience store operators include large grocery retailers, regional grocery retailers, symbol group retailers and independent non-affiliated convenience store operators. According to IGD, there are approximately 50,000 convenience stores in the UK.

3.11 Six symbol group retailers have more than 1,000 affiliated stores that are, in the main, convenience stores. These are Spar, Premier, Londis, Best-One, Costcutter, and Nisa-Today's (see Table 3.3). Large grocery retailers that operate significant numbers of convenience stores include CGL (1,300 stores), Tesco (1,200 stores), Sainsbury's (260 stores), and Somerfield (150 stores).

TABLE 3.3 **Symbol group retailers in the UK**

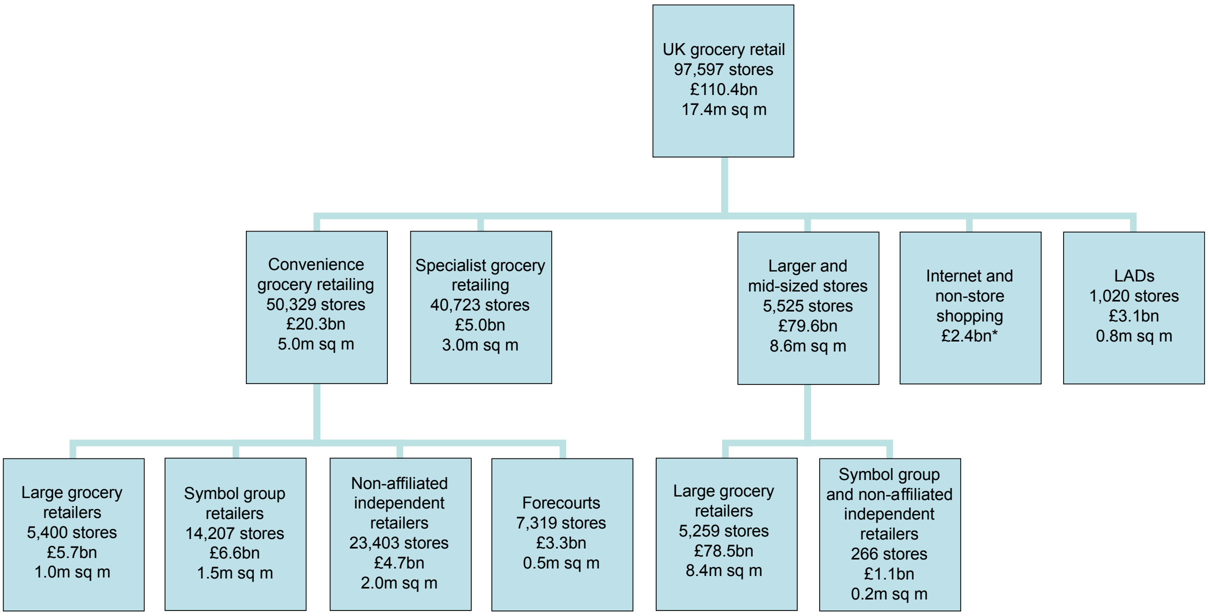
Symbol group	*No of stores*
Spar UK	2,742
Premier (Booker)	2,020
Londis (Musgrave)	1,896
Best-One (Bestway)	1,630
Costcutter	1,500
Nisa-Today's	1,132
P&H Retail (including Mace, Mace Express, Supershop and Your Store)	760
Key Store/Shop (Key Lekkerland)	310
Select & Save	145
VG/Vivo (Northern Ireland)	104
Budgens/Budgens Local (Musgrave)	101
Centra (Musgrave NI)	81

Source: The Knowledge Store, 2007.

3.12 Figure 3.2 sets out the structure of the UK grocery retail sector, including store numbers, sales and floorspace by category of grocery store and by category of grocery retailer. Convenience stores and specialist grocery stores account for more than 90 per cent of all grocery stores in the UK by number, but only around one-fifth by sales. Large and mid-sized grocery stores, while representing only 5 per cent of all grocery stores by number, account for nearly three-quarters of national grocery sales. Internet grocery sales are estimated to account for 1 to 2 per cent of total grocery sales.[1]

FIGURE 3.2

Structure of the UK grocery retail sector by store category



Source: IGD.
*It is not possible for IGD to estimate food and non-food items puchased through online shopping.
Notes:
1. Large grocery retailers includes regional Co-ops.
2. Conversion of sq feet to sq metres undertaken by the CC.
3. LADs store numbers obtained from Verdict, UK Grocery Retailers 2008, February 2008 and store size estimated by the CC to average 800 sq metres.

Trends in the number and size of grocery retailers and grocery stores

3.13 Key trends in UK grocery retailing since the 1950s include:

- growth in the number of larger grocery stores, including in out-of-town locations;
- a smaller number of large grocery retailers capturing an increasing share of grocery sales; and
- a decline in specialist grocery retailers.

3.14 Changes in the grocery retail offer over time (eg the shift from served to self-service grocery stores) and a lack of data make precise measurement of some of these trends difficult. However, the number of larger and mid-sized grocery stores is estimated to have grown from nearly 2000 in the mid-1960s to approximately 6,300 in 2000. Between 2000 and 2007, the number of larger and mid-sized grocery stores increased to nearly 6,600 stores representing annual growth of around 1 per cent, while the number of stores larger than 2,300 sq metres grew at about 3 per cent a

[1]IGD, *UK Grocery Outlook*, September 2007.

year.[1] Consistent with the increase in the number of larger and mid-sized stores, average store sizes increased as smaller stores were replaced with larger stores.[2] The number of larger stores located out-of-town increased from just under 300 in 1980 to more than 700 by 1990 and to almost 1,500 in 2007.[3]

3.15 In paragraph 3.4 we set out large grocery retailers' increasing share of national grocery sales in recent years. This reflects a long-term trend. The share of groceries being sold by large or regional grocery retailers increased from an estimated 20 per cent in 1950, to 44 per cent by 1971 and to 85 per cent by 2007. For much of the period from 1950 to the mid-1970s, the cooperative movement, through the various regional Co-ops, had the largest share of grocery sales in the UK. However, this position was overtaken, first by Sainsbury's in the 1980s, and subsequently in the 1990s, by Tesco.

3.16 The increasing share of national grocery sales by large grocery retailers is explained both by the opening of new stores and the acquisition of other grocery retailers. In the period since 2000 major acquisitions in the grocery retail sector have included:

- Morrisons' acquisition of Safeway in 2004;
- Tesco's acquisition of the convenience store operators T&S Stores in 2002 and Adminstores in 2004;
- Sainsbury's acquisition of the Jacksons, Beaumonts and Bells convenience store chains in 2004;
- CGL's acquisition of the convenience store operators Alldays in 2002, Balfour in 2003 and Conveco in 2004; and
- Somerfield's acquisition of 115 ex-Safeway stores from Morrisons in 2004.

Further details of these and a number of other acquisitions are set out in Table 3.4.

[1]IGD supplied data based on their series of reports now called *UK Grocery Outlook*, September 2007.
[2]Over the period 1971 to 1979, national and regional grocery retailers reduced their total number of stores by 45 per cent as small stores were replaced with fewer larger stores. For example, in 1978/79, grocery retailers closed more than 350 shops smaller than 500 sq metres and opened 60 stores of more than 900 sq metres. See Seth and Randall, *The Grocers: The Rise and Rise of the Supermarket Chains*, 1999, p19.
[3]Verdict, *UK Grocery Retailers*, series on the number of grocery stores larger than 2,320 sq metres.

TABLE 3.4 **Grocery retailer merger and acquisition activity, 2000 to 2007**

2000	Co-operative Wholesale Society merges with Co-operative Retail Services to form Co-operative Group (CWS) Limited (CGL) with 1,100 food stores post-merger
	Somerfield sells 46 stores to CGL, Asda, Sainsbury's, Tesco, Waitrose and Morrisons
2002	CGL acquires 600 Alldays convenience stores
	Tesco acquires 870 T&S stores
2003	CGL acquires 114 Balfour stores
2004	Morrisons acquires Safeway
	Waitrose acquires 19 Morrisons stores (14 ex-Safeway)
	Sainsbury's acquires 14 Morrisons (13 ex-Safeway), 114 Jacksons, 6 Beaumonts, and 54 Bells stores
	Somerfield acquires 115 stores from Morrisons (ex-Safeway)
	Tesco acquires 45 Adminstore stores including Europa, Harts and Cullens and 10 Morrisons stores (ex-Safeway)
	Asda acquires 4 Morrisons stores (ex-Safeway)
	CGL acquires 64 Conveco stores
2005	Sainsbury's acquires another 9 Morrisons stores (ex-Safeway) and 5 stores from SL Shaw
	Waitrose acquires 5 Morrisons stores (ex-Safeway)
	Asda acquires 12 Morrisons stores (ex-Safeway)
	Tesco acquires 21 petrol stations from Morrisons (ex-Safeway/BP)
2006	Waitrose acquires 5 stores from Somerfield
	Somerfield sells 248 Kwik Save Stores, including 171 stores to BTTF to trade under the Kwik Save fascia
	M&S acquires 28 Iceland and 12 Somerfield stores
2007	Kwik Save Limited is placed in administration
	Merger between CGL (approximately 1,700 stores) and United Co-operatives Limited (approximately 620 food stores)
2008	Somerfield's owners commence a sales process for the business

Source: Main parties, OFT.

Note: The list of transactions in this table is not exhaustive. There have, for example, been a number of mergers between regional Co-ops during this period.

3.17 The increasing share of national grocery sales by large grocery retailers has been accompanied by an expansion in the convenience store sector by large grocery retailers, most notably Sainsbury's and Tesco. Sainsbury's and Tesco now own approximately 4.5 per cent of all convenience stores in the UK. We discuss further the expansion of these retailers into the convenience store sector in paragraphs 5.88 to 5.98.

3.18 As we set out in paragraph 3.4, the national sales share of the LADs has also shown some growth in recent years, reflecting an increase in the number of stores for these retailers. The number of Aldi and Lidl stores has grown from around 240 stores each in 2000 to 360 and 465 stores respectively in 2007.[1] Netto had around 120 stores in 2000 and this has grown to around 180 by 2007.

3.19 The number of specialist grocery stores has declined significantly since the 1950s. The number of butchers and greengrocers declined from 40,000–45,000 each in the 1950s to fewer than 10,000 each by 2000. The number of bakeries declined from around 25,000 in 1950 to around 8,000 by 2000 and the number of fishmongers declined from around 10,000 to around 2,000 over the same period. We provide further details on trends in specialist grocery store numbers in Appendix 5.1.

Grocery retailer profitability

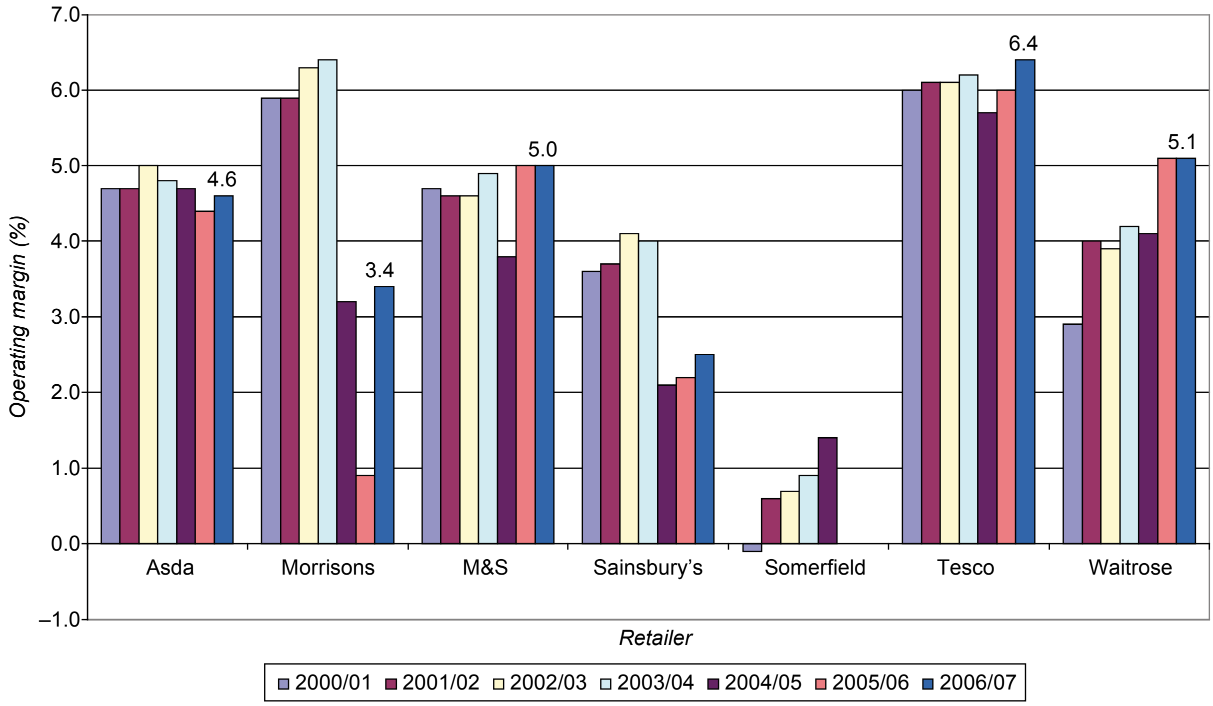
3.20 Operating margins for the UK operations of a number of large grocery retailers are shown in Figure 3.3. Average operating margins for these grocery retailers fluctuated between 3.6 to 4.5 per cent between 2000 and 2007. There were, however, significant variations between grocery retailers. Tesco consistently maintained an operating margin of around 6 per cent, while Asda and M&S earned operating margins of 4.5 to 5 per cent. Waitrose increased its margins over the period as did Somerfield, albeit from a lower base. Margins at both Sainsbury's and Morrisons declined in 2005 and

[1]Verdict, *UK Grocery Retailers*, 2008.

2006 compared with previous years although both experienced an upturn in 2007. In 2007, the four largest grocery retailers earned a combined profit of £3.6 billion.

FIGURE 3.3

UK grocery retailers, operating margins, 2000 to 2007



Source: IGD, UK Grocery Outlook, 2007.
Note: Somerfield data for 2005/06 is not available.

3.21 We found that large grocery retailers, on average, earn higher operating margins than independent retailers. The average operating margin for large grocery retailers of 3.6 to 4.5 per cent is higher than the 2.9 per cent average margin earned by the 50 largest independent grocery retailers in 2007.[1] As with large retailers, however, there were significant variations in the margins earned by these independent retailers, with reported profits margins ranging from 0 per cent for three independent retailers to more than 10 per cent for one independent retailer (Proudfoot Group).

3.22 We could not draw conclusions about the relative profit margins earned by large grocery retailers in the UK and retailers in other countries. A recent presentation to the [✂] by a major investment bank ([✂]) showed the profit margins of 12 grocery retailers from Australia, Belgium, France, Germany, the Netherlands and the US as well as the UK.[2] This showed Tesco as earning the fourth largest profit margin, while Sainsbury's and Morrisons rank eighth and tenth respectively.

3.23 While this does not indicate that UK grocery retailer profit margins are high in comparison with grocery retailers from other countries some care needs to be taken in interpreting these figures. The numbers reported are based on global operations of each of these retailers. Differences in accounting treatments between retailers may also affect the comparison. We examine the profit margins of large grocery retailers

[1]The Grocer, *The Top 50 Independents*, 23 February 2008. The 'Top 50 Independents' includes a selection of regional grocery retailers, independent non-affiliated convenience store operators and independently owned symbol group retailers.
[2][✂]

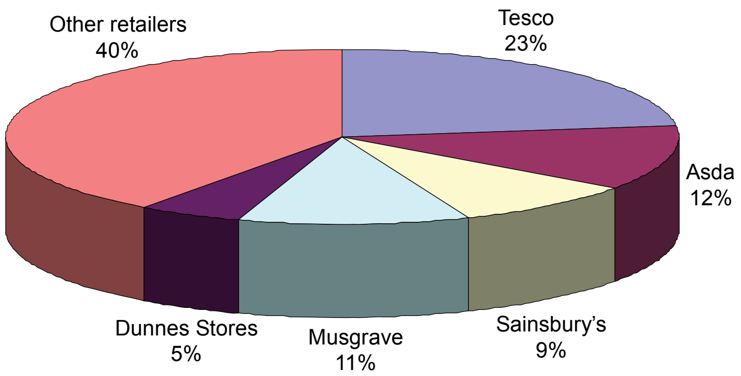
at the store level in paragraphs 6.52 to 6.59. We review international comparisons of grocery prices in paragraphs 3.43 to 3.45.

Grocery retailing in Northern Ireland

3.24 While, despite some regional variations, the structure of grocery retailing across Great Britain is broadly consistent, there are some more significant differences between grocery retailing in Great Britain and Northern Ireland. Of the four largest grocery retailers in the UK, Asda, Sainsbury's and Tesco started operating in Northern Ireland relatively recently, while Morrisons does not currently have any stores in Northern Ireland.[1] Tesco is the largest grocery retailer with 23 per cent of grocery sales in Northern Ireland. However, together, the share of total grocery sales in Northern Ireland for these three grocery retailers, at 44 per cent, is significantly less than their share in Great Britain (approximately 55 per cent). Two other grocery retailers, Musgrave and Dunnes, have a combined share of 16 per cent of total grocery sales in Northern Ireland.

FIGURE 3.4

Northern Ireland grocery sales share, 2006



Source: Mintel, Food Retailing, 2007.

3.25 There are also fewer independent non-affiliated convenience stores in Northern Ireland than in other parts of the UK. Symbol group stores in Northern Ireland also tend to be larger than those in Great Britain. In contrast to Great Britain, an exemption to Sunday trading restrictions for shops that sell fuel[2] means that many of these symbol group stores sell fuel, particularly in rural areas.

Grocery wholesalers and buying groups

3.26 Grocery wholesalers and buying groups are a key part of the UK grocery sector. (Buying groups are affiliations of several wholesalers that have been established to obtain more favourable terms from suppliers than each wholesaler could achieve individually.) Regional grocery retailers, symbol group retailers and operators of independent non-affiliated convenience stores generally source grocery supplies through grocery wholesalers and buying groups. This is in contrast to large grocery retailers

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[1] Sainsbury's and Tesco opened their first stores in Northern Ireland in 1996 and Asda in 2005 (via its acquisition of 12 former Safeway stores from Morrisons).
[2] Shops (Sunday Trading &c) (Northern Ireland) Order 1997.

that have integrated wholesaling functions (ie they purchase supplies directly from food and drink manufacturers).[1]

3.27 There are more than 400 grocery wholesalers in the UK. The 15 largest grocery wholesalers account for more than three-quarters of grocery wholesaling revenues, while the two largest grocery wholesalers, Palmer & Harvey McLane and Booker, account for around half of grocery wholesaling revenues.

3.28 There are two major segments in grocery wholesaling: cash-and-carry wholesalers and delivered wholesalers. Cash-and-carry wholesalers primarily supply independent non-affiliated convenience stores, while delivered wholesalers primarily supply symbol group retailers that operate convenience stores. In recent years, however, the distinction between cash-and-carry wholesalers and delivered wholesalers has become less clear as some cash-and-carry wholesalers, such as Booker, have developed their own symbol groups to which they deliver supplies. Of the £17.5 billion in revenues for grocery wholesaling in 2006, those wholesalers primarily engaged in cash-and-carry wholesaling accounted for approximately 54 per cent, while those wholesalers primarily engaged in delivered wholesaling accounted for the remaining 46 per cent.

3.29 Most of the major UK grocery wholesalers are affiliated to a buying group (see Table 3.5). Buying groups may also have an affiliated symbol group.

TABLE 3.5 **Major grocery wholesalers and their symbol group or buying group affiliations**

Company	*Principal mode of operation*	*Turnover* £m	*Share of revenues* %	*Symbol group*	*Buying group affiliation*
Palmer & Harvey McLane Ltd	Delivered	3,533	20.8	Mace, Mace Express, Super Shop	
Booker Ltd	Cash and carry	3,228	19.0	Premier	
Bestway Cash & Carry Ltd (incl Batleys)	Cash and carry	1,600	9.4	Best One	
Makro Self Service Wholesalers Ltd	Cash and carry	1,100	6.5		Today's
Costco Wholesale UK Ltd	Cash and carry	953	5.6		
AF Blakemore and Son Ltd	Delivered	622	3.7	Spar	Spar
Londis (Holdings) Ltd	Delivered	527	3.1	Londis	Today's
James Hall and Company (Holdings) Ltd	Delivered	314	1.8	Spar	Spar
Dhamecha Foods Ltd	Cash and carry	271	1.6		Today's
Capper & Co Ltd	Delivered	253	1.5	Spar	Spar
CJ Lang & Son Ltd	Delivered	237	1.4	Spar	Spar
Henderson Wholesale Ltd	Delivered	233	1.4	Spar	Spar
AG Parfett & Sons Ltd	Cash and carry	219	1.3		Landmark
JW Filshill Ltd	Delivered	147	0.9		Key Leckerland
Appleby Westward Group plc	Delivered	142	0.8	Spar	Spar
Total		13,502	78.8		

Source: IGD and Companies House.

Suppliers to grocery retailers

3.30 Large grocery retailers, as we set out in paragraph 3.3, purchase goods directly from grocery suppliers, while regional grocery retailers, symbol group retailers and convenience store operators tend to purchase goods from suppliers through wholesalers and buying groups. The following paragraphs provide an overview of the structure of

[1]Large grocery retailers, however, tend to purchase fresh produce from produce wholesalers rather than directly from primary producers. We discuss this further in paragraphs 3.30 to 3.34.

the supply chain for grocery retailers, including both food and drink manufacturers and primary producers.

3.31 There are a large number of firms that supply groceries to UK grocery retailers either directly or indirectly. This includes food and drink manufacturers, primary producers and fresh food wholesalers, including packers, processors and wholesalers. There are approximately 311,000 farm holdings, 3,600 fresh food intermediaries and 6,600 food and drink manufacturers in the UK.[1]

3.32 Grocery retailers purchase relatively little of their fresh produce directly from UK farmers.[2] Most fresh produce is supplied to grocery retailers through intermediaries such as packers, processors and fresh food wholesalers. Six large grocery retailers (Asda, M&S, Morrisons, Sainsbury's, Somerfield and Tesco) told us that the combined total value of their direct purchases from farmers amounted to approximately £295 million in 2006.[3] This compares to £14.3 billion in total agricultural production annually and £16.7 billion in fresh food sales by these grocery retailers in total.[4]

3.33 The limited value of direct purchases by grocery retailers from farmers can, however, understate the closeness of the trading relationship between primary producers and grocery retailers. For example, farmers may be members of, or shareholders in, intermediary businesses that market their produce to grocery retailers. Further, the figures cited above do not include transactions with processors that are vertically integrated with primary production.

3.34 There is a large variation in the size of businesses supplying grocery retailers. Grocery suppliers include branded goods' producers, such as Coca-Cola, Unilever, Kimberly-Clark and Procter & Gamble. However, many small businesses also provide products to grocery retailers. Our survey of groceries suppliers indicates that around one-fifth of groceries suppliers earn less than £1 million a year from the sale of groceries (see Figure 3.5).

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[1] Defra, http://statistics.defra.gov.uk/esg/publications/auk/2006/excel.asp. Not all of these businesses necessarily supply grocery retailers. A significant number may supply food services businesses (eg restaurants, caterers) or the export market rather than grocery retailers.

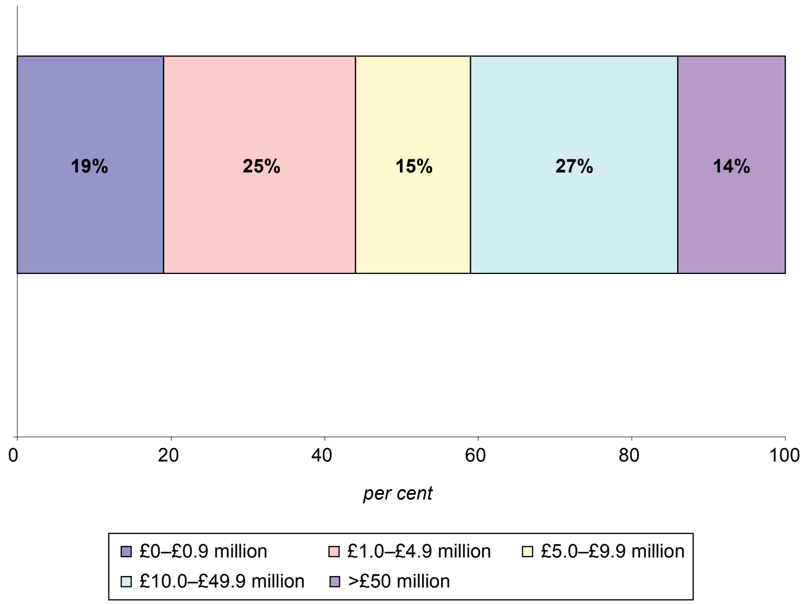
[2] Grocery retailers provided a number of reasons for the purchasing of fresh produce through intermediaries rather than directly from farmers. These included: efficiencies arising from a single intermediary undertaking processing/packing on behalf of a number of farmers; the costs to a grocery retailer of trying to deal individually with the large number of farmers that would be required to supply a grocery retailer's total fresh food volume requirements; the effectiveness of intermediaries at carrying out quality assurance activities compared with grocery retailers; and intermediaries greater ability to source alternative supplies where there is a shortfall in domestic production compared with grocery retailers.

[3] Morrisons accounted for the majority of these direct purchases, primarily as a result of its greater degree of vertical integration into food processing compared with other major grocery retailers. The largest category (by value of purchases) of the six grocery retailers was vegetables, including salad vegetables, at around £175 million. This was followed by red meat purchases at around £75 million.

[4] Grocery retailers are not unusual in their purchase of fresh produce through intermediaries. For example, [✂], a major UK food manufacturer, told us that it purchased directly from few, if any, UK farmers.

FIGURE 3.5

Suppliers to UK grocery retailers, by grocery revenue



Source: GfK, *Research on Suppliers to the UK Grocery Market: A Report for the Competition Commission*, 15 January 2007.
Note: The GfK sample size was 426 suppliers.

3.35 There is some evidence of consolidation in the groceries supply chain in recent years. There are examples of supply chain consolidation in the milk processing, sugar distribution, salt and carbonated soft drinks sectors since 2000.[1] The Department for Environment, Food and Rural Affairs has observed that concentration is high in the food and drink manufacturing industry and that there has been a net exit from the sector in the past decade.[2]

3.36 Consolidation among grocery retailers may also have encouraged consolidation in the groceries supply chain. In the context of another inquiry, the CC was recently told by two grocery retailers that 'sourcing from fewer suppliers reduced the complexity in buying and was usually more economic for suppliers, who could therefore offer a more competitive price'.[3] However, one grocery retailer ([✂]) told us that supplier consolidation is driven by factors other than retailer behaviour. It said that its own sourcing policy in fresh produce was towards more local sourcing and fragmenting its supply base to reduce transport costs and exposure to climatic volatility.

3.37 Our review of the red meat, pig-meat and fresh fruit supply chains in Appendices 9.4 to 9.6 also shows some consolidation among processors and other intermediaries in the supply chain. This is consistent with research indicating that grocery retailers have sought to reduce costs in fresh produce by reducing the number of suppliers in

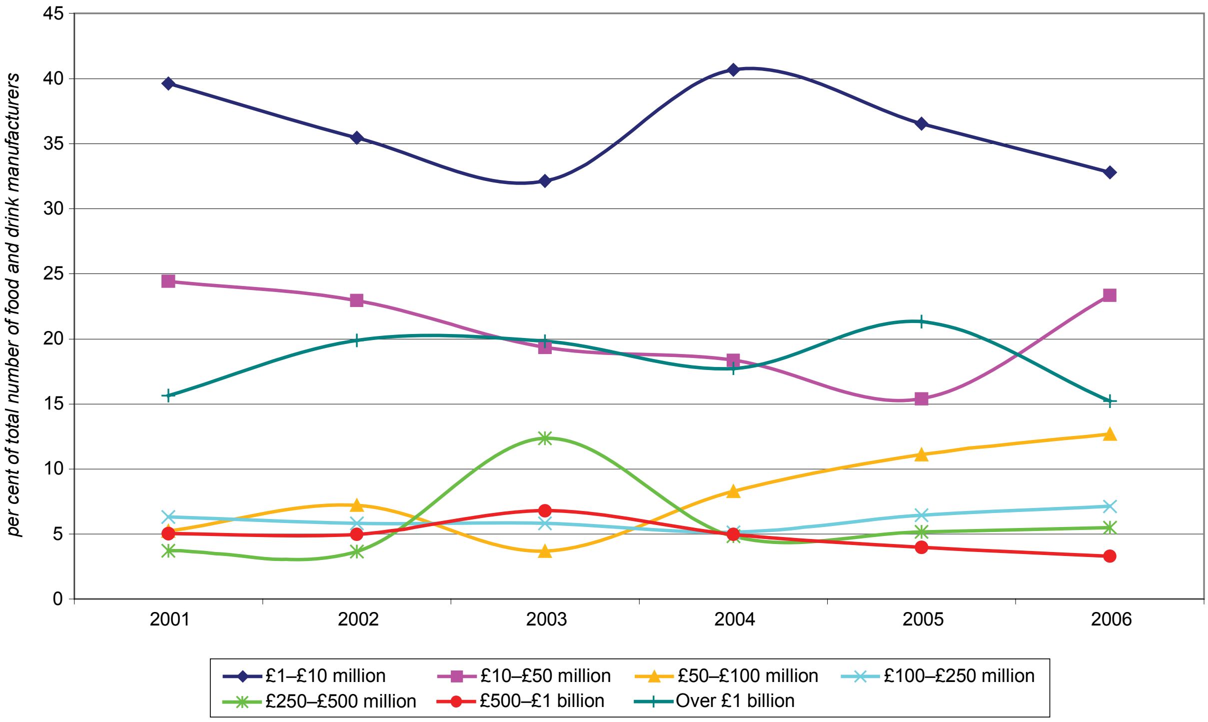
[1]See *Arla Foods amba and Express Dairies plc: a report on the proposed merger*, October 2003; *James Budgett Sugars Ltd and Napier Brown Foods PLC: a report on the acquisition by Napier Brown Foods PLC of James Budgett Sugars Ltd*, March 2005; *British Salt Limited and New Cheshire Salt Works Limited: a report on the acquisition by British Salt Limited of New Cheshire Salt Works Limited*, November 2005; *HJ Heinz and HP Foods: a report on the completed acquisition of the HP Foods companies by HJ Heinz Company and HJ Heinz Company Ltd*, 24 March 2006; and *Cott Beverages Limited and Macaw (Holdings) Limited: a report on the acquisition by Cott Beverages Limited of Macaw (Holdings) Limited*, 28 April 2006 (all published by TSO and available on our website).
[2]UK Food and Drink Manufacturing: an economic analysis (September 2007), pp 30–31: http://statistics.defra.gov.uk/esg/reports/FDM%20paperFINAL%2007.pdf.
[3]See *Cott Beverages Limited and Macaw (Holdings) Limited*, CC, 28 April 2006, p9.

each product category, thus encouraging consolidation among upstream intermediaries.[1]

3.38 The distribution of food and drink manufacturers by revenue does not, however, show a clear movement towards larger firms (see Figure 3.6) although these statistics cover firms supplying the food services sector and the export market as well as grocery retailers. The overall picture, in our view, is more complex than a single overriding trend towards consolidation. While there is clearly some consolidation occurring in some parts of the groceries supply chain, which has important implications for our consideration of issues such as coordinated behaviour (see Section 8), niche entry by small firms also appears to be taking place.

FIGURE 3.6

Food and drink manufacturers, by total revenue, 2000 to 2006



Source: The Knowledge Store, 2007.
Notes:
1. Average of around 4,000 food manufacturers each year.
2. The years 2001 to 2003 include a pro-rata distribution, made by the CC, of a category of suppliers that had a turnover of greater than £50 million. This allowed comparison with data categories measured in the period 2004 to 2006.
3. Data for 2006 has had two new and additional categories covering suppliers with turnover less than £1 million. This data has been removed in this figure for consistency with prior years.

[1]'The search for improved supply chain integrity and greater consistency in the quality of fresh produce coupled with the need to squeeze costs out of the supply chain … has resulted in the rationalisation of the supply base, with retailers seeking to deal with fewer, larger, technically efficient and innovative suppliers. The major supermarkets now deal with just a handful of suppliers in key product areas (potatoes, root vegetables, brassicas, salads, top fruit, stone fruit and soft fruit) and take every opportunity to pass responsibility (and associated costs) for quality control and procurement, storage and distribution upstream to their key suppliers, in return for which the chosen few are rewarded with volume growth' in Fearne and Hughes, 'Success factors in the fresh produce supply chain: insights from the UK, *Supply Chain Management*, 4(3), 1999, pp 120–128. One publicly documented example of a reduction in the number of suppliers is by Waitrose. Reportedly, Waitrose reduced the number of its fruit suppliers from more than 100 to around 15, with one key supplier for each major category. (See O'Keeffe and Fearne, 'From commodity marketing to category management: insights from the Waitrose category leadership program in fresh produce', *Supply Chain Management*, 7(5), 2002, pp 296–301.)

Trends in grocery prices and product range

3.39 The following paragraphs set out trends in prices and product range for grocery retailers. Price and product range are key concerns for consumers. There are, however, many other factors that, together with pricing and product range, constitute the grocery retailer's offer to consumers (the 'retail offer'). These other factors include the quality of products (eg freshness), store layout, store location, availability of food counters and other store amenities, store cleanliness, parking facilities and opening hours. In assessing the impact of competition on the retail offer, we need to take account of all of these variables. In paragraph 4.16, we discuss the retail offer in the context of market definition, and in paragraphs 6.34 to 6.51, we discuss different ways to measure the retail offer.

Grocery prices

3.40 Food prices declined, in real terms, by around 8 per cent between 2000 and August 2007 (see Figure 3.7). This continued the trend observed in our 2000 investigation which showed a decline of 9.4 per cent in the real price of food from 1989 to 1999. This decline in real food prices is likely to have delivered significant benefits to consumers as shopping bills for the same basket of goods would now be lower in real terms than was the case seven years ago. This is also consistent with the long-term trend where spending on food in the UK has increased five-fold in the past 30 years while national disposable income has increased 12-fold.[1]

3.41 However, real food prices have increased by more than 3 per cent between August 2007 and January 2008, and the most recent figures show that they are now at a similar level to 2005 (see Figure 3.7). The Cabinet Office reports that a variety of demand- and supply-side factors—including higher energy and transport costs—have converged to cause recent price increases, and prices seem unlikely to return to their previous lows in the next few years.[2]

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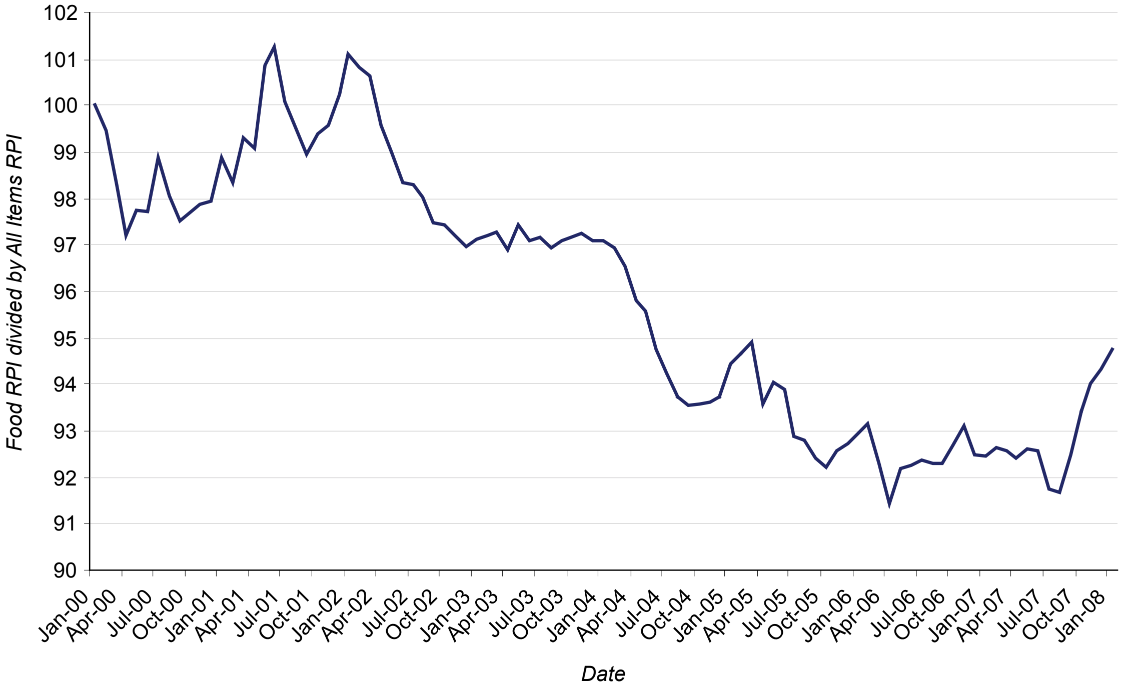
[1]ONS, *Use of Disposable Income Account*, 2007—as reported by the Cabinet Office, *Food: an analysis of the issues*, January 2008, p24.
[2]ONS Household Sector, *Use of Disposable Income Account*, 2007 and ONS, *Consumer Trends*, 2007—as reported by the Cabinet Office, *Food: an analysis of the issues*, January 2008, p24.

FIGURE 3.7

Changes in real food prices



Source: CC analysis based on ONS Retail Price Index data.

3.42 There are many different influences on grocery prices. These include the cost factors identified in paragraph 3.41 as well as the degree of competition between grocery retailers. The overall decline in real grocery prices that has been observed over recent years has been beneficial for consumers. This does not necessarily suggest, however, that there are no features of the market which prevent, restrict or distort competition. It may be that grocery prices would have been lower if competitive conditions had been different.

3.43 International comparisons of prices and price trends are another means of looking at the effectiveness of competition between grocery retailers. There are, however, several problems associated with international price comparisons. Different countries have different consumer tastes and shopping behaviour, for example, that lead to substantial differences in the structure of grocery retailing. Further, exchange rate issues, difficulties in the comparability of products and pack sizes, differences in the role of tax in food prices, and different property markets and planning regimes all impact differentially on the prices of groceries in different countries. Moreover, price is only one aspect of the grocery retail offer, and grocery retailer margins may provide a better indication of the effectiveness of competition. (We discuss grocery retailer margins in paragraphs 3.20 to 3.23.)

3.44 Nevertheless, concerns have been expressed about the rate of recent food price increases in the UK compared with other EU countries.[1] Eurostat data on grocery price levels across the EU and other European countries suggests that prices in the

[1]Specifically, that an increase of 2 to 3 per cent in food prices in other EU countries should be compared with, approximately, a 6 per cent increase in food prices in the UK. See 'Food price inflation is hard to stomach', *Scotland on Sunday,* 3 June 2007.

UK for food and non-alcoholic beverages are approximately 13 per cent above the average for the 27 EU Member States.[1]

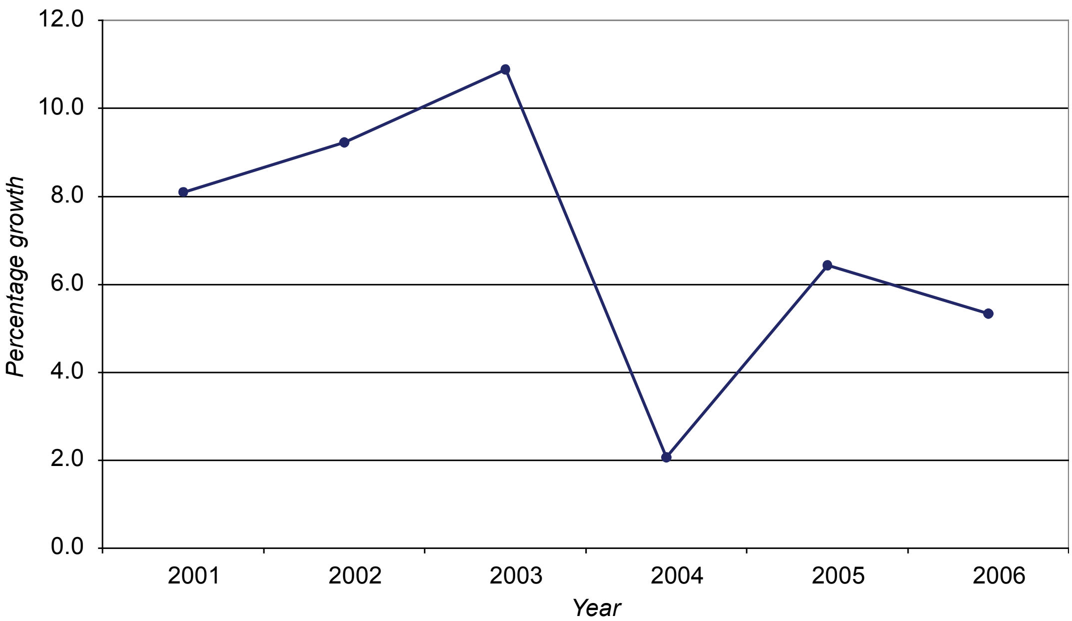
3.45 While the Eurostat data may indeed give a valid picture of relative price levels, given the issues set out in paragraph 3.43, we believe that there is only limited value to be gained from an extensive cross-country comparison of grocery prices for the purposes of informing an assessment of the effectiveness of competition in UK grocery retailing. As a result, we have not sought to further inform our investigation through such an analysis.[2]

Product range

3.46 Grocery retailers' product range has increased since 2000 and, in particular, we observed a significant increase in the number of products stocked by the four largest grocery retailers (see Figure 3.8). This increase amounts to an average of approximately 2,000 new grocery and non-grocery products each year for each of the four largest grocery retailers.[3]

FIGURE 3.8

Growth in grocery retailers' grocery and non-grocery product lines



Source: CC calculations based on data provided by Asda, Morrisons, Sainsbury's and Tesco.

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[1]Eurostat (2007), *Eating, drinking, smoking—comparative price levels in 37 European countries for 2006*, Statistics Focus 90/07. This covers the pricing of approximately 500 products in Spring 2006. UK prices for meat and fruit and vegetables were considerably above the EU-27 average (26 per cent and 20 per cent respectively), whereas UK prices for fish were approximately 9 per cent below the EU-27 average.
[2]In the 2000 investigation, an international price comparison was undertaken. This was mainly because the the origin of that reference lay in the widespread concern that UK consumers were paying higher prices for groceries than consumers in other countries (see paragraph 2.3). The difficulties of making international price comparisons are discussed further in the report from the 2000 investigation (see *Supermarkets: a report on the supply of groceries from multiple stores in the UK, Volume 2: Background chapters*, CC, October 2000, Chapter 9).
[3]There are significant differences in the way the retailers measure the number of SKUs available during the year, which makes direct comparison between retailers difficult. For example, some measure a weekly average while others measure the total number of products offered within a one-year period, which will include lines only on offer for limited periods of time, eg Christmas.

Consumers of groceries

3.47 The following paragraphs review three issues specific to consumers, namely:

- shopping missions and shopping frequency;
- the extent of store choice available to grocery consumers; and
- consumer satisfaction with grocery retailing.

Shopping missions and shopping frequency

3.48 In previous inquiries into grocery retailing (see paragraph 2.2), we used shopping missions, namely main, secondary and convenience shopping, as a means of defining groups of consumers for the purpose of defining the relevant market, which in turn provides a framework within which to assess the effectiveness of competition. (We discuss market definition further in Section 4.)

3.49 Shopping frequency, and its links to the size of an average shopping trip, provides some indication of the extent to which consumers might be willing to substitute between stores of different sizes. In our 2000 investigation we found that approximately 70 per cent of customers carried out a main shopping trip once a week, while 16 per cent of customers carried out a main shop more than once a week. CGL submitted survey results showing that 70 per cent of customers undertake a main shop once a week—a figure that is consistent with the results reported in 2000.[1] Asda also told us that the importance of one-stop-shopping missions remained stable over the period 2005 to 2006, and evidence that the distribution of basket sizes in large grocery retailers has remained broadly constant between 2003/04 and 2005/06 indicates that shopping patterns have not changed significantly.

3.50 IGD research, however, suggests that this proportion had declined to approximately 59 per cent in 2007 with a larger proportion of consumers shopping more frequently.[2] Evidence from other sources also suggests that consumer shopping frequency may have increased. Research undertaken for grocery retailers indicates that customers now visit supermarkets more often than previously.[3] Further, demographic changes appear to be supporting growth in convenience shopping. Households are becoming smaller with the growth in the proportion of elderly and single people leading to increases in smaller shopping missions with more tendency to top-up. In assessing the importance of different shopping missions, we also noted that there is no consensus on a standardized way of segmenting customers according to shopping mission. Other different missions that can also potentially be identified include bulk, top-up, and entertainment shopping.[4] We further discuss the role of shopping missions in our approach to market definition in this investigation in paragraphs 4.38 to 4.42.

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[1]Oxera, *Analysis of shopping missions: results of a telephone survey*, 5 June 2007. The survey results were based on 545 household respondents.
[2]IGD, *Shopper Trends in Product and Store Choice*, 2007.
[3]For example, a comparison of shopping missions in 2003 and 2004 shows that the number of shopping trips for top-up purposes increased by 3.6 per cent for general groceries and 6.2 per cent for fresh food. Further, the number of 'single need' (or convenience) shopping trips increased by 8.2 per cent for general groceries and 10.6 per cent for fresh food. By way of comparison, the number of 'stock-up' (or main) shopping trips increased by only 1 per cent (TNS, *Category performance and offer vs competitors: research for Sainsbury's*, April 2005).
[4]IGD, *Category Management*, 2006.

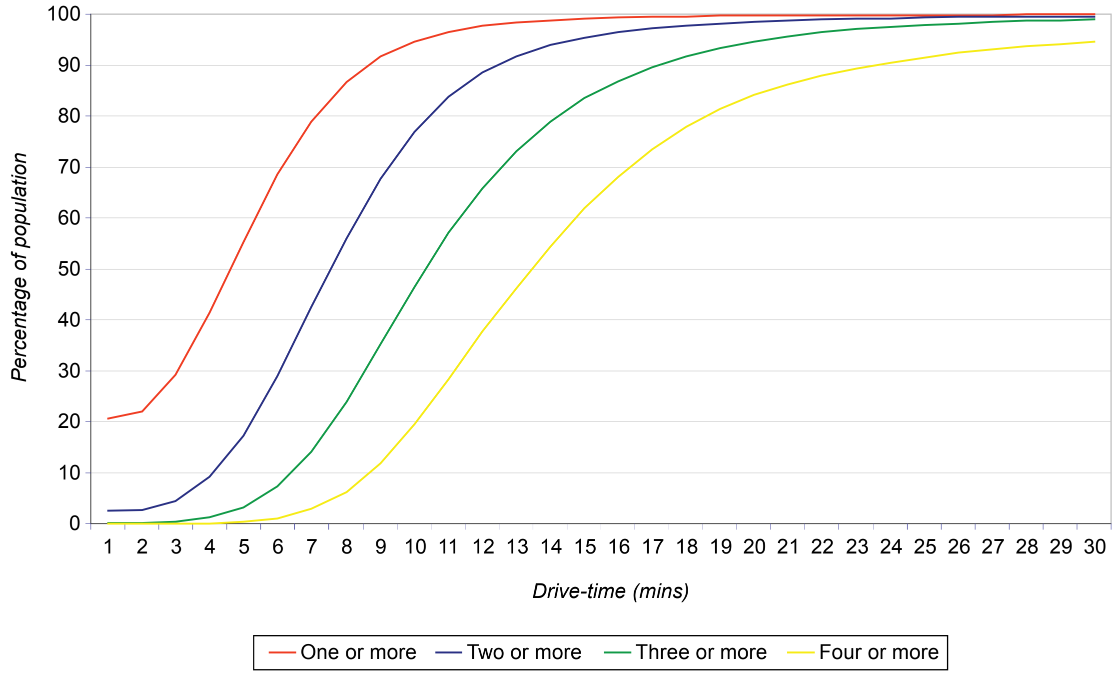
Store choice

3.51 Public concerns about the extent of store choice for consumers have arisen since our 2000 investigation in the form of public debate about so-called 'Tesco towns' where a single retailer has a large concentration of stores.

3.52 Our analysis indicates that 95 per cent of the UK population living in urban areas has access to at least one grocery store larger than 1,400 sq metres within a 10-minute drive-time.[1] Further, 20 per cent of the urban population has a choice of at least four stores of different fascia larger than 1,400 sq metres within a 10-minute drive-time (see Figure 3.9).

FIGURE 3.9

Proportion of the UK urban population with a choice of one, two, three or four grocery stores each with a different fascia and larger than 1,400 sq metres



Source: CACI analysis of parties' data submissions.

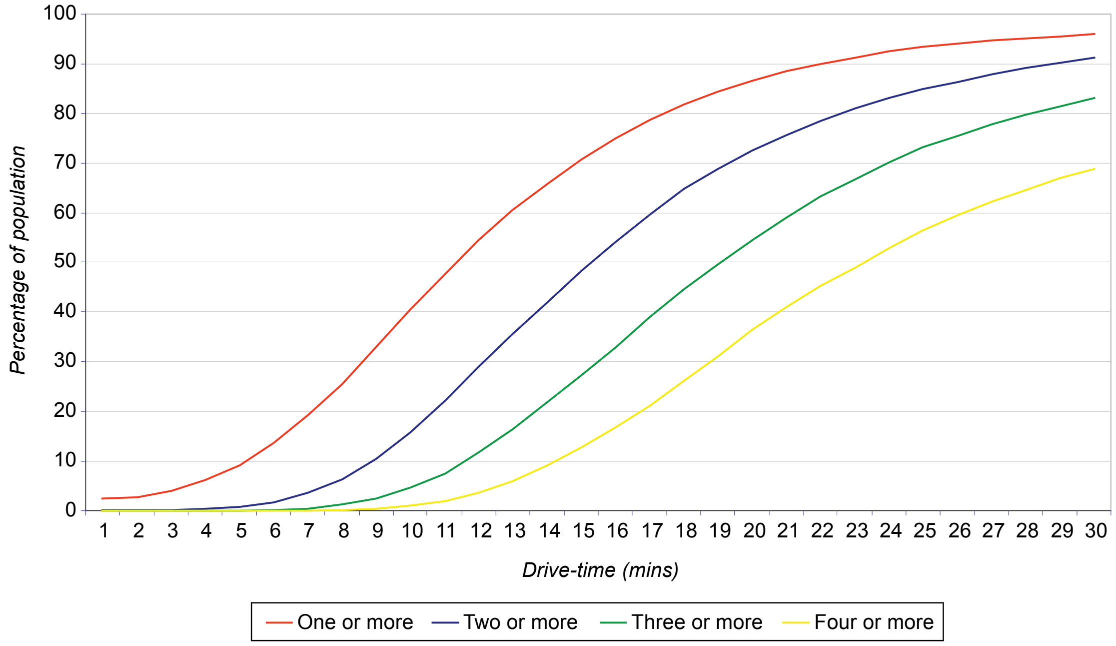
3.53 In rural areas, 71 per cent of the population has access to at least one grocery store larger than 1,400 sq metres within a 15-minute drive-time (see Figure 3.10), and 13 per cent of the population has a choice of at least four stores of different fascia larger than 1,400 sq metres within a 15-minute drive-time.

3.54 This indicates that a large proportion of the urban and rural population in the UK is able to choose between at least two larger grocery stores within a reasonable drive-time. Nevertheless, these national-level figures will mask substantial regional variations. In Section 6, we assess the extent to which local markets for grocery retailing are highly concentrated. We also take the extent of store choice into account when assessing the overall effectiveness of competition in grocery retailing in Section 10.

[1] Appendix 3.2 sets out the methodology we have used for calculating drive-times.

FIGURE 3.10

Proportion of the UK rural population with a choice of one, two, three or four grocery stores each with a different fascia and larger than 1,400 sq metres



Source: CACI analysis of parties' data submissions.

Consumer satisfaction

3.55 The extent of, and trends in, consumer satisfaction with grocery retailing may provide some evidence, albeit indirect, of the effectiveness of competition in grocery retailing. We looked at the Advanced Institute of Management Research (AIM) study on consumer satisfaction with local grocery retailing[1] and a British Brands Group (BBG) study on consumer shopping wants and UK grocery retailing.[2]

3.56 The AIM study explored the collection of stores necessary to achieve consumer satisfaction. It concluded that a Tesco supermarket made the greatest contribution to overall satisfaction, but consumer satisfaction was highest when a variety of stores was available. The presence of a small store within 5 minutes is significantly valued by consumers, but consumers were largely indifferent to the ownership of this store. There was little linkage between consumer satisfaction and the degree of retailer concentration that was observed. (We note, however, that, for the purposes of this study, retailer concentration was measured at the town level rather than at the 10- to 15-minute drive-time isochrone level that we use in much of our analysis.)

3.57 The BBG study examined the shopping requirements of four different sub-groups of consumers (older consumers, wealthier consumers, ethnic consumers and single parents) and the extent to which the existing grocery retail structure meets their requirements. The majority of customers in the BBG study accepted the store choice that is available, but a substantial minority were unhappy with their choice of stores

[1]Are consumers getting what they *REALLY* want?, Initial Findings from a Major Survey of Consumer Satisfaction with their Local Selection of Grocery Stores. Presented at a Workshop 15 June 2007. See: www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/third_party_submissions_other_org_advanced_institute.pdf.
[2]Don Edwards & Associates Limited, the Red Hot Group, and IRI, *Consumer shopping wants and UK grocery retailing: Are consumer needs being met?* A study undertaken for the British Brands Group, July 2007. See www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/third_party_submissions_bbg_3.pdf.

and, especially, their choice of specialist stores.[1] However, as with the AIM study, the BBG study found that supermarkets met a broad range of needs for a wide range of customers. Where a supermarket has an offer of price, quality and choice that is at least as good as the average, it will be the preferred store because of its ability to provide a one-stop-shopping solution.

4. Market definition

4.1 In this section we identify, for the purposes of our competition analysis, the framework within which competition takes place. To this end, we need to identify the grocery stores that impose a significant competitive constraint on each other. This is known as defining the relevant 'market' where each market is described in both 'product' and 'geographic' terms.

4.2 The key to identifying stores that are in the same market is assessing the extent to which customers regard different stores as effective substitutes for each other. That is, the stores that should be included in the same market are those to which customers will switch when the store at which they are currently shopping increases its prices.[2] By identifying those stores that are in the same market, we can analyse the effectiveness of competition in that market.

4.3 Market definition can seem a complex, technical exercise for those that are not familiar with competition analysis. Often, the markets that are identified for the purposes of competition analysis are different from those that are commonly discussed by businesses or customers. In many cases, businesses or customers refer to entire industries or product sectors when using the term 'market'.[3] However, our approach ensures that we have defined the market as rigorously as possible, and, as a result, have a sound framework for analysing competition.[4]

4.4 We expect that the results of our market definition assessment in this investigation will inform future inquiries in this sector. We are, however, conscious that our assessment will only remain valid as long as the evidence on which it is based remains a reliable representation of consumer behaviour and preferences. This is why each time the CC has examined grocery retailing in recent years (see paragraph 2.2), we considered the issue of market definition afresh.[5]

4.5 The remainder of this section provides our analysis of, first, the relevant product market, and second, the relevant geographic market. Prior to this, however, we explain our methodology for defining the relevant market.

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[1]The study found that the trend in the composition of retail outlets, where it results in lower prices, is welcomed by lone parents more than the other groups. Wealthier persons and the elderly, subject to access and affordability constraints, wish to purchase from specialist stores. Ethnic groups are well catered to by, and have high demand for, specialist store offerings that are not matched by the supermarkets.

[2]Customer switching between stores is referred to as demand-side substitution. We might also include other stores in the same product (or geographic) market based on supply-side substitution—that is, where a store can readily switch its product offering so that it starts to offer an effective substitute for consumers shopping at a store that increases prices.

[3]For the purposes of defining a market for competition analysis, we are most interested in those options that customers have for switching their purchases now or in the near future. We will also take into account options that might become available to consumers in the longer term, but this will be in the context of our competition analysis rather than in defining the market. This approach can result in differences between the way in which competitive constraints are identified for the purposes of market definition compared with the way in which a business might perceive the competitive constraints it is facing over the longer term. In some cases this difference may have little practical effect. However, in other cases, differences might arise as a result of different assessments of the extent of these longer-term competitive threats.

[4]In this section we focus on defining markets for the supply of groceries by grocery retailers. We consider upstream markets in the context of our consideration of competition issues in the groceries supply chain in Section 9.

[5]A summary of the CC's findings on market definition in previous inquiries into grocery retailing is contained in Appendix 4.1.

Methodology for defining the relevant market

4.6 The generally accepted conceptual approach to market definition, which is used by the CC, is the hypothetical monopolist test (also known as the SSNIP—small but significant non-transitorty increase in prices—test). The principle behind the test is that a market is defined as a product, or collection of products, the supply of which can, hypothetically, be monopolized profitably.[1]

4.7 The extent to which a profit-maximizing hypothetical monopolist controlling grocery stores in a candidate market will be able to impose a SSNIP will be determined by the scope for demand- and supply-side substitution. In the context of grocery retailing, demand-side substitution occurs when consumers switch either all or part of their grocery expenditure to another store. This might be in response to a change in price, but may also be in response to a change in one or more of the other non-price aspects on which stores compete such as product range, quality or service. As a result, we take into account possible changes in both price and non-price factors when considering demand- and supply-side substitution.[2]

4.8 Supply-side substitution occurs when a price increase prompts other companies to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will typically come from companies with existing facilities, providing similar products and/or operating in adjacent areas. There are several obstacles that a retailer would need to overcome if it were to start supplying the market at short notice. These obstacles might have both a product and a geographic dimension.

4.9 A retailer might, for example, need to adjust its product range so as to start supplying the relevant market. It would need to establish relationships with new suppliers, and may require the expansion of its store. If it needed a new store to supply the relevant market, this would involve acquiring a suitable site and (where necessary) planning consent. It is likely to be costly and time-consuming to overcome these obstacles, and as a result, we found that supply-side substitution was not likely to take place.

4.10 There are many different possible starting points for a hypothetical monopolist test, and the starting point for a test can affect the outcome. This is because any two grocery stores may not necessarily impose an equal competitive constraint on each other. In our analysis of the product market for grocery retailing, particularly in relation to store size, we therefore apply a number of different starting points for a hypothetical monopolist test (eg larger grocery stores, mid-sized grocery stores and convenience stores—see paragraphs 4.53 to 4.63).

4.11 The CC normally uses a 5 per cent price increase for the hypothetical monopolist test because, in many instances, an increase in the price of a product of around 5 per cent might reasonably be judged to have a significant effect on customers' expenditure. However, in some cases, as set out in the CC's guidelines, a 5 per cent price increase might be an inappropriate level at which to conduct the hypothetical monopolist test. Given the importance of groceries expenditure in the household

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[1]In conducting a SSNIP test, an initial candidate market, which should be the smallest market possible, is first defined. If a profit maximizing hypothetical monopolist in that candidate market could not profitably impose a SSNIP, due to customers switching to other products, then the candidate market is expanded. The process is repeated until a market is found in which a SSNIP could be profitably imposed.

[2]When considering non-price factors, however, an application of the hypothetical monopolist test is not straightforward. Although a change in non-price factors sheds light on demand-side substitution and thus the extent of competition between firms, it is more difficult to assess the impact of a change in non-price factors on supplier profitability. In the remainder of this section we use the term 'price increase' when discussing the application of the hypothetical monopolist test. However, this also encompasses an equivalent deterioration in non-price factors.

budget, we think that the appropriate price increase for assessing the relevant market for the supply of groceries is likely to be less than 5 per cent. In addition, as grocery retailing is characterized by high sales volumes and small profit margins, a 5 per cent price increase is unlikely to be profitable. In this situation it is not unusual to consider a smaller price increase.[1]

4.12 As in any other investigation, we consider a range of evidence to assess the outcome of a SSNIP test. Our assessment of the likely behaviour of consumers when faced with a price increase might be informed by, for example, evidence of past consumer behaviour, or by elasticities of demand.[2] Observations on how grocery retailers react to one another's efforts to gain new customers, for example through local promotional activity following entry by a rival, can provide useful information on which stores are substitutes for consumers.

4.13 We undertook a substantial amount of complex econometric and other quantitative analysis to inform our market definition. This included: *(a)* econometric modelling of consumer demand for groceries (see paragraphs 4.104 to 4.105), *(b)* an analysis of the relationship between store profit margins and local concentration (see paragraphs 4.106 to 4.113), *(c)* an analysis of the impact of new stores on the revenues of existing stores (see paragraphs 4.114 to 4.116), and *(d)* a review of a simulation model of the SSNIP test submitted by Tesco (see paragraphs 4.117 to 4.131).

4.14 Econometric analysis and other modelling cannot, in isolation, provide a definitive answer to the question of market definition. This type of analysis can be sensitive to the assumptions on which it is based or the nature of the data that is used. In some cases, it is not possible to develop a model that is sophisticated enough to approximate usefully real world interactions. As a result, we have ensured that we have considered the econometric and other quantitative analysis alongside other evidence.

Product market

4.15 Groceries, as defined in our terms of reference, include food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods.[3] Consumers, in purchasing groceries, have a choice of a wide range of stores. These include larger grocery stores, mid-sized grocery stores, convenience stores, LADs stores, frozen food stores and specialist grocery stores.

4.16 There are many factors that differentiate grocery stores. As set out in paragraph 3.39, these include price, range (or number) of products, quality of products, service levels, store layout, store location, food counters, cleanliness, parking facilities and opening hours. We refer to these factors as the 'retail offer'. Some of these factors, such as price, quality, range and service (PQRS),[4] can be varied by retailers relatively easily; but other factors, such as parking facilities and the number of checkouts, are less easily changed. In assessing changes in price and non-price factors for the purposes of market definition, we look at changes in PQRS rather than

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[1] In the investigation of the merger between Whole Food Markets and WildOats both the US Federal Trade Commission and the parties agreed that a 1 per cent price increase was an appropriate threshold for the purposes of market definition.
[2] The price elasticity of demand is measured as the percentage change in demand for a product that follows a given percentage change in price. It is also possible to consider elasticity of demand with respect to non-price factors.
[3] The definition of groceries in our terms of reference specifically excludes petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers, magazines, greeting cards, CDs, DVDs, video and audio tapes, toys, plants, flowers, perfumes, cosmetics, electrical appliances, kitchen hardware, gardening equipment, books, tobacco and tobacco products.
[4] See *Somerfield plc/Wm Morrison Supermarkets plc: a report on the acquisition by Somerfield plc of 115 stores from Wm Morrison Supermarkets plc*, CC, September 2005.

changes in the entire retail offer as it is the PQRS factors that can be changed quickly and easily.

4.17 Notwithstanding the many differentiating factors between stores, there are two observable variables which capture many aspects of the retail offer of any given store. These are, first, store size, and second, the identity of the store operator (ie store fascia). As a result, our analysis of the relevant product market, and the way in which we describe the competitive constraints facing different grocery stores, is described in terms of these two variables.

4.18 This approach differs from the shopping-mission-centred approach adopted by the CC in previous inquiries (see paragraph 3.48 and Appendix 4.1). The CC identified three primary shopping missions—main, secondary and convenience shopping. It then considered the extent to which different grocery stores could effectively meet the requirements of these different shopping missions. The grocery stores that were identified as being effective substitutes for each other for customers carrying out each type of shopping mission were then described in terms of store size and store fascia.

4.19 In this investigation we moved away from the shopping mission as the starting point for our consideration of market definition. A number of parties argued that shopping patterns have changed since 2000, and in particular, consumers have shifted away from a weekly shop to more frequent shopping trips. The evidence for this is mixed (see paragraphs 3.48 to 3.50). However, as we acknowledged in previous inquiries, there is an imperfect match between shopping mission and store size. As a result, if we are to describe the product market in terms of store size, we think it appropriate to assess directly the substitutability of stores of different sizes. Nevertheless, the scope for customers on a particular type of shopping mission to switch some or all of their expenditure to a different-sized store in response to a price increase (or other deterioration in the retail offer) will be relevant to our assessment.

Store size

4.20 In assessing the extent to which stores of different sizes place an effective competitive constraint on each other, such that it warrants including them in the same product market, we discuss in the following paragraphs:

- the extent to which the number of product lines (or stock-keeping units—SKUs) in a store varies with store size (see paragraphs 4.22 to 4.24);
- the presence of different food counters and other amenities in stores of different sizes (see paragraphs 4.25 to 4.32);
- the store size distribution of grocery stores in the UK as well as within the portfolios of individual grocery retailers (see paragraphs 4.33 to 4.37);
- consumer shopping patterns in relation to different store sizes (see paragraphs 4.38 to 4.42);
- a model of consumer demand for groceries (see paragraphs 4.43 to 4.48); and
- the impact of the entry of new grocery stores on the revenues of different-sized grocery stores (see paragraphs 4.49 to 4.52).

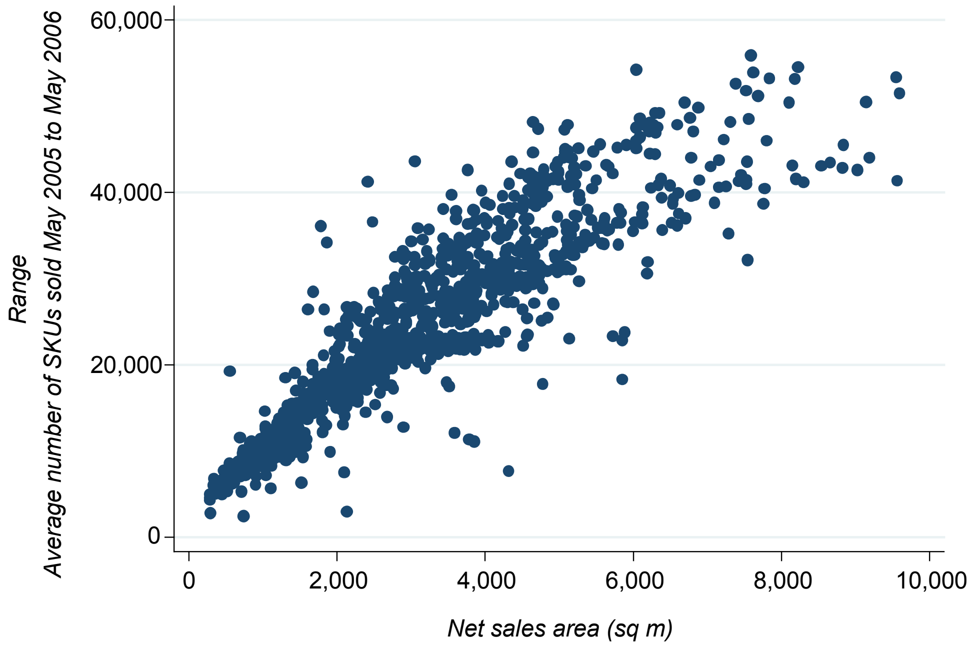
4.21 We then assess this evidence in the context of the hypothetical monopolist test to reach conclusions regarding the extent to which the relevant product markets can be delineated by store size.

Variation in product range by store size

4.22 Variation in product range across stores of different sizes affects how a consumer would view these stores as substitutes. Figure 4.1 shows the relationship between store size and product range, including both grocery and non-grocery products, at Asda, Morrisons and Tesco stores in the UK. This shows a strong relationship between store size and product range for stores with a net sales area larger than 280 sq metres. This relationship between store size and product range supports the view that customers may not find stores with less floorspace an effective substitute for stores with more floorspace due to their smaller range of products.

FIGURE 4.1

Store size and product range (including non-grocery): Tesco, Asda and Morrisons



Source: CC analysis.
Note: Sainsbury's was not able to provide comparable data and so is not included in this figure.

4.23 Asda provided us with further data that shows that the number of grocery SKUs remains stable or increases relatively slowly with store size at its own stores (see Figure 4.2). Stores of [✂] to [✂] sq metres will generally carry in the range of [✂] to [✂] grocery SKUs, while stores larger than [✂] sq metres will generally offer around [✂] grocery SKUs. The number of grocery SKUs at stores smaller than [✂] sq metres falls quite dramatically. However, Asda operates only [✂] stores smaller than [✂] sq metres.

4.24 Nevertheless, the data provided by Asda indicates that consumers are likely to regard grocery stores larger than a certain minimum size as good substitutes for each other given that they each carry a very similar number of grocery products. However, stores with more floorspace will carry a more extensive non-grocery offering. The availability of non-grocery products may also influence the extent to which customers regard one store as a substitute for another store.

FIGURE 4.2

Grocery and non-grocery product range by store size for Asda

[✂]

Source: Asda.

Variation in food counters and other amenity offerings by store size

4.25 In the same way that product range can be expected to influence customers' willingness to substitute between stores of different sizes, we also thought that the availability of different food counters and other store amenities might be expected to influence customers' willingness to substitute between stores of different sizes. We examined how the availability of different food counters and amenities varies with store size. In general, we found that stores with more floorspace offer a greater range of food counters and other amenities than smaller stores.

4.26 We examined the availability of four different types of food counter (delicatessen, fish, bakery and meat) at eight large grocery retailers (Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose). Table 4.1 shows how the availability of different food counters varies across stores of different sizes.

TABLE 4.1 **Proportion of stores with food counter by size group**

per cent

Food counter	*<280 sq m*	*280–1,000 sq m*	*280–1,400 sq m*	*280–2,000 sq m*	*>1,000 sq m*	*>1,400 sq m*	*>2,000 sq m*
Fish	0	1	5	14	65	78	87
Meat	0	2	6	12	50	60	66
Delicatessen	1	19	30	39	86	93	97
Bakery	60	83	85	87	97	98	99
Total number of stores	2,763	1,486	1,981	2,434	2,333	1,838	1,385

Source: CC analysis.

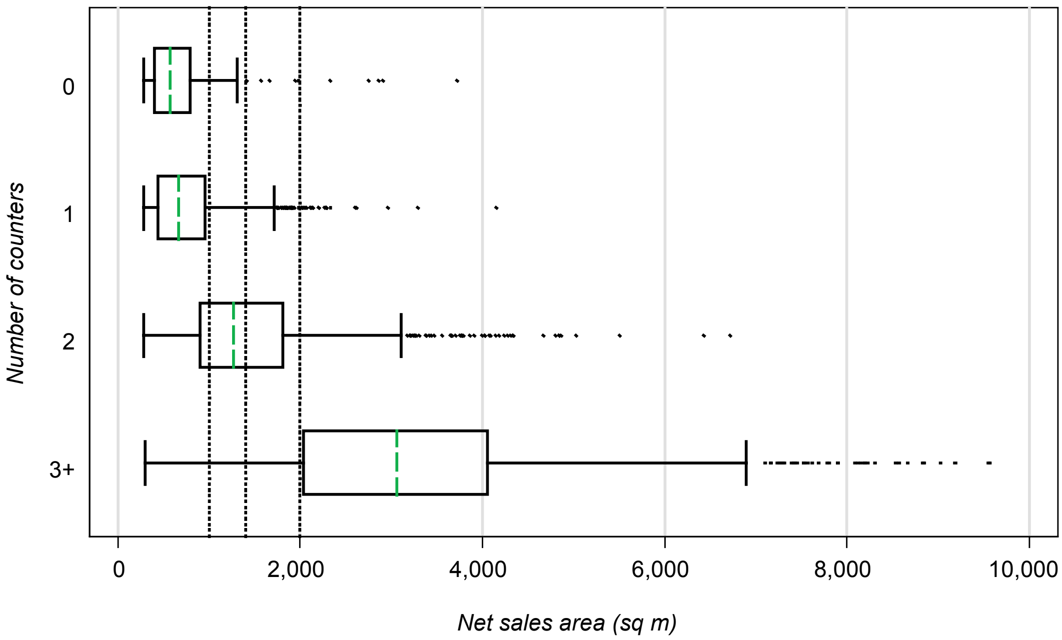
Note: The bakery data captures both ''bake-off' and 'scratch' offers. As a result, some small stores are classed as having an in-store bakery when in practice they offer a limited 'bake-off' range. However, in other instances bake-off will provide a close substitute to scratch. As a result, some caution is required when interpreting the results.

4.27 In general, stores smaller than 280 sq metres do not have fish, meat or delicatessen counters, but a significant proportion (60 per cent) have in-store bakeries. There is a rapid increase in the availability of delicatessen and bakery counters for stores larger than 280 sq metres. Further, there appears to be a substantial increase in the availability of these different food counters at stores larger than 1,000 sq metres compared with stores of 280 to 1,000 sq metres. For example, 65 per cent of stores larger than 1,000 sq metres have a fish counter compared with only 1 per cent of stores of 280 to 1,000 sq metres.

4.28 The total number of food counters available in each store also increases with store size (see Figure 4.3). Nearly 75 per cent of stores that have two food counters are larger than 1,000 sq metres, and more than 75 per cent of stores that have three or more food counters are larger than 2,000 sq metres. More than 75 per cent of stores that only have one food counter are smaller than 1,000 sq metres.

FIGURE 4.3

Number of food counters available, by store size



Source: CC analysis.
Note: The first vertical dotted line indicates 1,000 sq metres; the second vertical dotted line indicates 1,400 sq metres; and the third vertical dotted line indicates 2,000 sq metres.

4.29 The availability of a range of other amenities, such as parking, ATMs and petrol filling stations, at stores of different sizes is shown in Table 4.2. Relatively few of these amenities, with the exception of ATMs, are available at stores smaller than 280 sq metres.

4.30 For each of the seven amenities shown in Table 4.2, there is a substantial increase in availability for stores larger than 1,000 sq metres compared with stores of 280 to 1,000 sq metres.

TABLE 4.2 **Proportion of stores with each amenity, by size group**

per cent

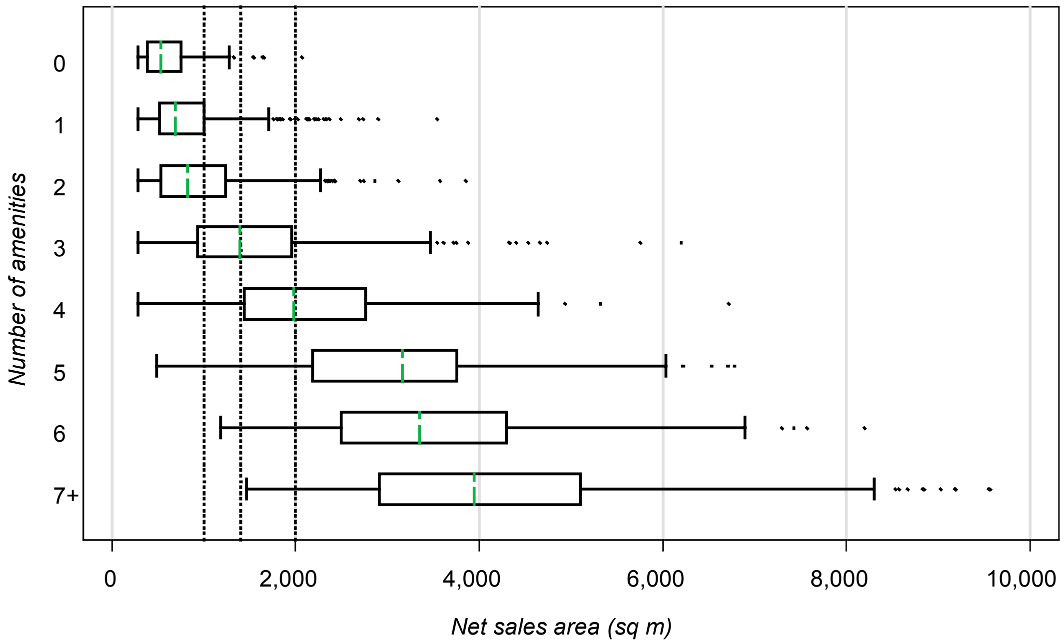
Variable	*<280 sq m*	*280–1,000 sq m*	*280–1,400 sq m*	*280–2,000 sq m*	*>1,000 sq m*	*>1,400 sq m*	*>2,000 sq m*
Parking	18	48	54	61	93	98	99
Toilets	4	11	17	27	78	90	96
ATM	56	46	48	52	80	88	94
Café	0	3	4	10	54	67	77
Petrol	7	9	9	11	44	55	67
Photo processing	0	2	4	8	38	46	54
Pharmacy	0	1	1	4	24	31	35
Total number of stores	3,504	1,760	2,292	2,771	2,403	1,871	1,392

Source: CC analysis of data provided by Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose.

4.31 The number of amenities that is available at a store increases with store size. Figure 4.4 shows that nearly 75 per cent of stores that have three of more of the various amenities that we studied are larger than 1,000 sq metres. More than 75 per cent of stores with five or more amenities are larger than 2,000 sq metres.

FIGURE 4.4

Number of amenities available, by store size



Source: CC analysis of data provided by Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose.
Note: The first vertical dotted line indicates 1,000 sq metres; the second vertical dotted line indicates 1,400 sq metres; and the third vertical dotted line indicates 2,000 sq metres.

4.32 Some stores may also offer services and products that are not commonly available in other stores, such as National Lottery tickets,[1] bill-paying facilities (Paypoint and Payzone) and mobile phone top-up cards. The ACS told us that these products form part of the convenience store product offering, despite the relatively low margins that they earn, due to their ability to attract customers.[2] The availability of this differentiated product offering in at least some convenience stores may indicate that some customers at these stores may not be willing to substitute shopping at other stores for a convenience store.

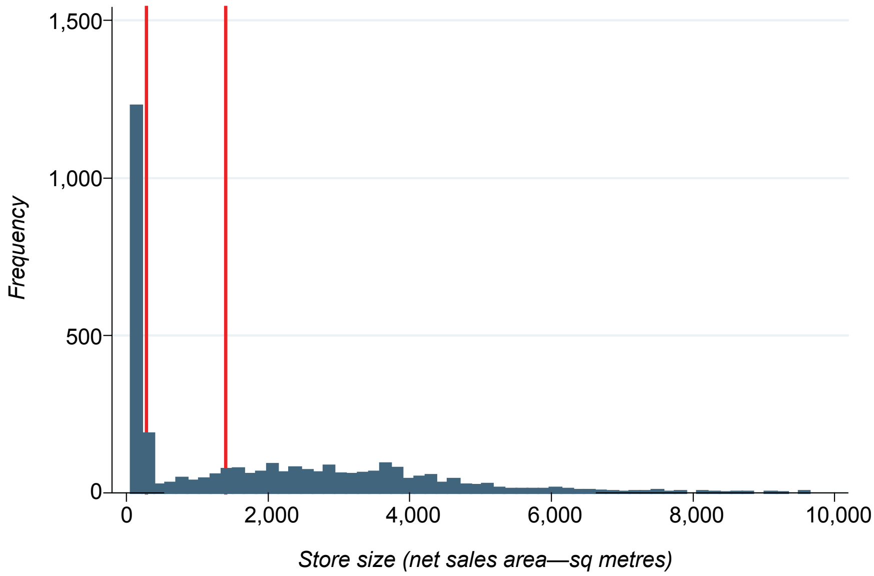
Distribution of store sizes for major UK grocery retailers

4.33 We looked at the distribution of UK grocery stores by store size. Any discontinuity in the distribution by store size may reflect consumers' willingness to shop at stores of different sizes. The distribution of grocery stores by size for the four largest grocery retailers is shown in Figures 4.5 and 4.6. These show that there is a concentration of stores just below the 280 sq metre net sales area threshold, in particular. This concentration is, in large part, driven by the Sunday trading laws that allow stores with a net sales area of less than 280 sq metres to open for extended hours.[3]

[1]The ACS estimates that no more than one in three convenience stores has a lottery terminal.
[2]See Europe Economics, *The Modelling of Independent Convenience Stores*, November 2006 submitted to the CC on behalf of the ACS.
[3]Sunday Trading Act 1994, section 1(1) and Schedule 1.

FIGURE 4.5

Distribution of stores for the four largest grocery retailers

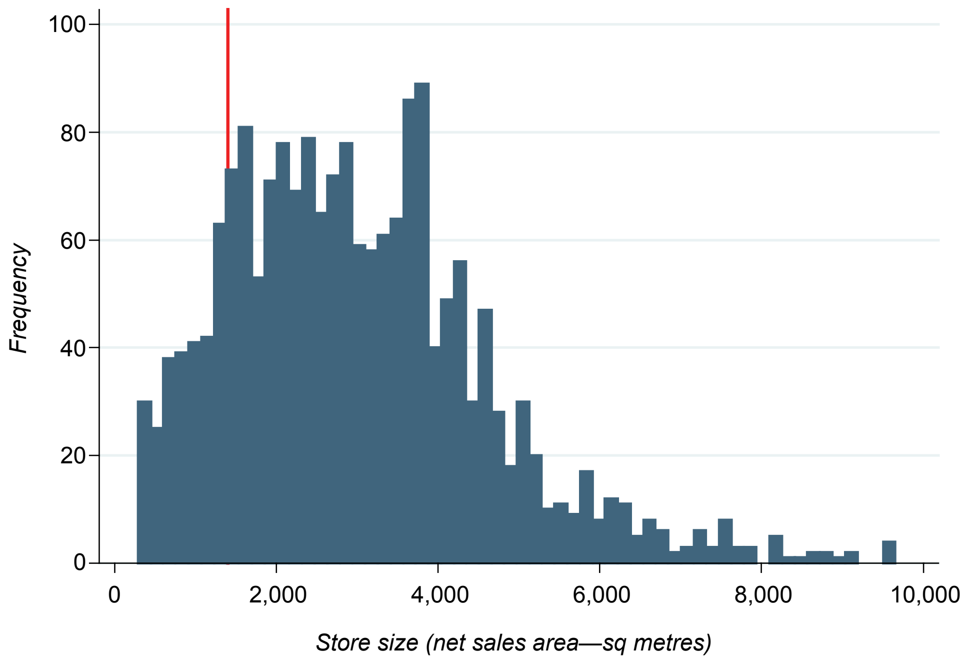


Source: CC analysis.
Note: Vertical lines are drawn at 280 sq metres and 1,400 sq metres.

4.34 In terms of stores larger than 280 sq metres, any discontinuity in the distribution of store sizes is less clear-cut. Figure 4.6 indicates possible discontinuities at around 1,200 to 1,400 sq metres and again at around 4,000 sq metres. We believe that the decline in store numbers that is observed for stores larger than 4,000 sq metres is likely to reflect, among other factors, the difficulties of obtaining suitable sites and planning permission for such stores (see paragraphs 7.35 to 7.44). As a result, we do not think that this particular discontinuity is necessarily indicative of consumer preferences.

FIGURE 4.6

Distribution of stores larger than 280 sq metres for the four largest grocery retailers



Source: CC analysis of questionnaire responses.
Note: Vertical line is drawn at 1,400 sq metres.

Variations in store size by grocery retailer

4.35 The store size range operated by a grocery retailer will reflect the types of customers that it is seeking to target. For example, Asda and Morrisons both told us that they targeted customers with large shopping baskets conducting a weekly shop. On the other hand, CGL has a strategy of primarily seeking to serve customers undertaking secondary or top-up shopping (including convenience shopping), while Somerfield targets customers that shop on the high street and at their local neighbourhood stores.

4.36 Given these strategies, it is possible to examine the range of store sizes operated by these grocery retailers, and infer the size of stores that retailers consider suitable for serving these different types of customers. Asda primarily operates stores larger than 2,000 sq metres and Morrisons primarily operates stores larger than 1,400 sq metres, while CGL and Somerfield primarily operate stores smaller than 1,400 sq metres (see Table 3.1 in Section 3).

4.37 Other grocery retailers, in their submissions to us, placed less emphasis on the type of customer that they are seeking to target. Sainsbury's[1] and Tesco[2] do not appear to have a particular customer target group, and this is consistent with their operation of a broad range of store sizes. However, both Sainsbury's and Tesco operate a number of different store formats that are associated with stores of different sizes. Again, this is consistent with a view that different customers may associate stores of different sizes with a different retail offer.

Consumer shopping patterns

4.38 In paragraphs 4.22 to 4.37 we reviewed evidence on how store characteristics vary with store size and discussed what this might mean in terms of consumers' willingness to substitute between stores of different sizes. In paragraphs 4.39 to 4.48, we assess more direct evidence of consumer shopping at stores of different sizes. We, first, review statistics on consumer expenditure, second, examine the results of a model of consumer demand (see paragraphs 4.43 to 4.48 and Appendix 4.2), and finally, review our analysis of the impact of new store entry on the revenues of incumbent stores (see paragraphs 4.49 to 4.52).

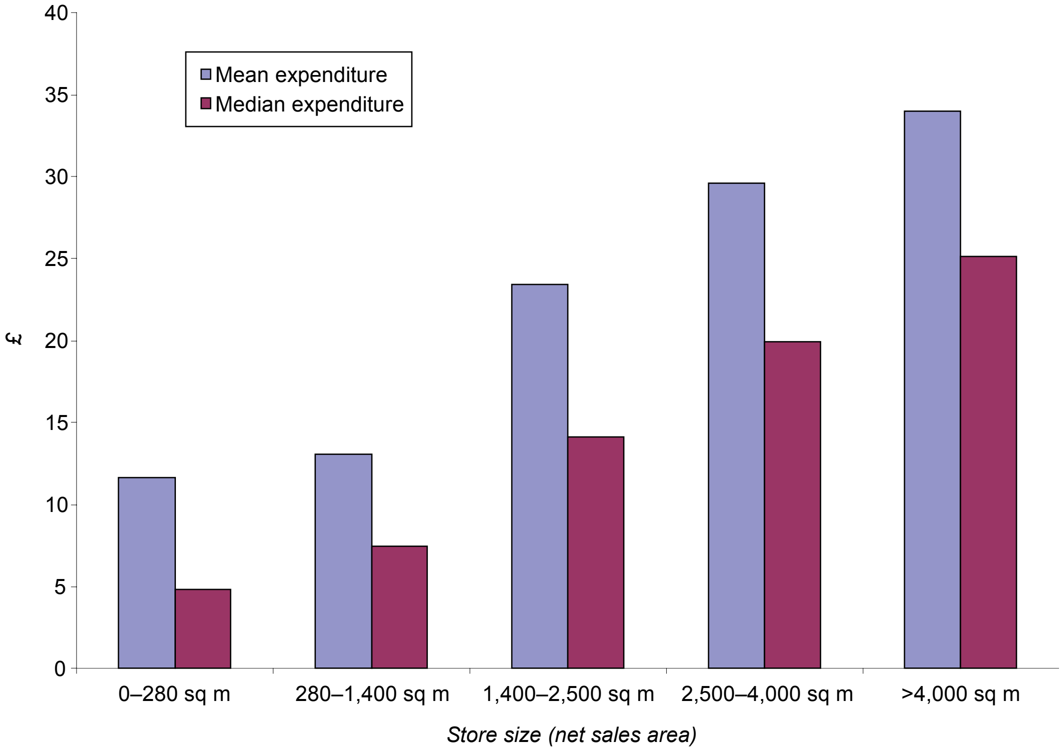
4.39 Average expenditure per shopping trip for customers increases with store size. Median expenditure in a store smaller than 280 sq metres is approximately £4.80 per shopping trip, but this increases to nearly £20.00 per shopping trip at a store that is between 2,500 sq metres and 4,000 sq metres (see Figure 4.7). If all grocery stores were perfectly substitutable for one another, we might expect to see a similar level of average expenditure at each store regardless of size. This evidence is indicative that consumers view stores of different sizes as substantially different in terms of their retail offer.

[1]Sainsbury's told us that it aims for universal customer appeal, so it does not target a particular customer group. This is consistent with its operation of a wide range of store sizes and a broad range of products. Sainsbury's told us that it operates two different store formats (convenience and one-stop). Stores less than 280 sq metres are operated as a convenience format and stores larger than 1,400 sq metres as a one-stop supermarket. For stores between 280 and 1,400 sq metres, the format is not only associated with size but also with local need and conditions.

[2]Tesco told us that its strategy was to appeal to a 'broad church' customer base and to reflect the demographics of the UK as a whole. It explained that it used a number of different segmentation techniques to develop a detailed understanding of what different customers wanted and why they shopped with Tesco. It explained that its retail formats had been developed to meet the needs of customers and of changing planning and transport policy. For example, Tesco believed that its customers valued the convenience offered by its Express format.

FIGURE 4.7

Average expenditure per shopping trip



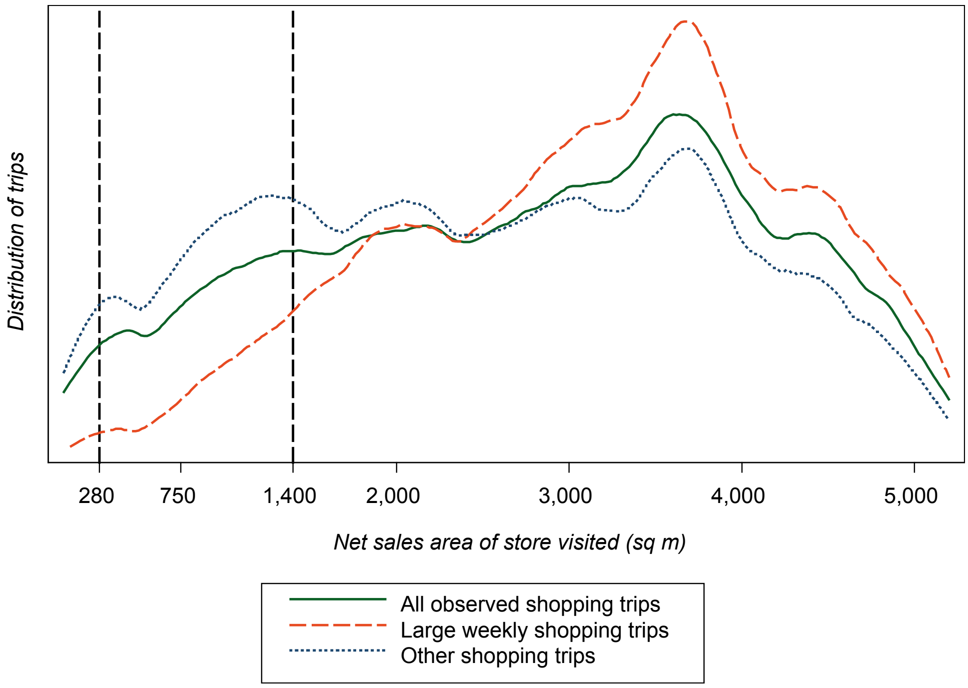
Source: CC analysis of TNS data.

4.40 In paragraphs 3.48 to 3.50, we review recent trends in shopping patterns, and in particular, the evidence of more frequent shopping by many consumers. To the extent that there are more of these customers, there is likely to be greater substitutability between stores of different sizes. Nevertheless, there remains a substantial proportion of the population that continue to conduct a single, main weekly shop. For some of these consumers, at least, this is likely to necessitate shopping at a grocery store of a certain minimum size and these consumers may have limited willingness to conduct these shopping trips at smaller stores.

4.41 Figure 4.8 shows the distribution of household shopping trips by store size where shopping trips are defined in terms of large weekly shopping trips (more than 60 per cent of household weekly grocery expenditure) and other shopping trips. This shows that, for large weekly shopping trips, a high proportion occur in stores larger than 1,400 sq metres. Figure 4.8 shows a fairly even distribution of other shopping trips over stores of different sizes. This shows that for other shopping trips consumers view all stores as good substitutes, but that consumers, in general, view stores larger than 1,400 sq metres as more suitable for large weekly shopping trips.

FIGURE 4.8

Store size distribution of household shopping trips, October 2006



Source: CC analysis of cleaned TNS data covering a four-week period during October 2006.
Note: This distribution is a Kernel density estimate, which is a smoothed histogram.

4.42 Customers doing large weekly shopping trips at stores larger than 1,400 sq metres are likely to be less willing to switch to smaller stores following a small price increase. For stores larger than 1,400 sq metres, customers on these shopping trips are the most important type of customer, accounting for around three-quarters of revenue. However, customers doing large weekly shopping trips at stores smaller than 1,400 sq metres are likely to be willing to switch to larger stores following a price increase. These weekly shopping trips account for approximately half of the revenue of these stores.

Econometric analysis of consumer demand

4.43 Using data from the shopping behaviour of approximately 13,000 UK households, we constructed an econometric model to explain consumers' choice of grocery store. In simple terms, we use this model to predict the behaviour of households in response to a change in the non-price components of PQRS (ie QRS) by comparing the observed pattern of store choice for households that share similar characteristics but face a different QRS offer and store choices. In predicting how households would react to a worsening of the offer at a store where they currently shop, we assume that those households facing a worse offer would change their choice of store in a way that was consistent with those households with similar characteristics that currently face a worsened offer.

4.44 We have not included a price variable in the model as most grocery retailers for which we have data have uniform national pricing.[1] This problem remains even when

[1]This means that it is difficult with cross-sectional data, which records a single observation per store, to disentangle price and fascia effects as these two variables do not vary across stores of the same fascia.

using prices net of discounts and other promotional offers. Instead, we rely on other aspects of the retail offer to predict a household's reaction to a small but significant change in the retail offer, in particular: *(a)* product availability and *(b)* the level of retail service at each store (as measured by the number of staff).

4.45 Full details of our model are provided in Appendix 4.2. In short, however, the various factors that we identified in our model as relevant to store choice are able to explain much of the observed pattern of store choice among households in the dataset. As a result, we believe that the model's predictions of store choice following changes to the underlying variables that we have identified as influencing store choice are robust.

4.46 In relation to the store-size delineation of the product market, we have used the model to predict how consumers shopping at stores larger than 1,400 sq metres and larger than 2,000 sq metres would react following a small but significant worsening of the QRS offer at their current store. In doing so, we examine both large weekly shopping trips and other shopping trips.[1]

4.47 The results show that the vast majority (ie more than 90 per cent) of those customers that switch to another store following a worsening of the offer at their current store switch to another store in the same size bracket if one is available (see Table 4.3). The proportion of customers that switch to other stores in the same size bracket is slightly higher when the threshold is set at 1,400 sq metres compared with 2,000 sq metres, and it is also slightly higher for large weekly shopping trips compared with other shopping trips. However, in each case, more than half of customers that switch stores switch to another store in the same size bracket.

TABLE 4.3 **Proportion of marginal shoppers at larger stores switching to other larger stores, 5 per cent change in product availability**

per cent

	Large weekly shopping trips		*Other shopping trips*	
Fascia	*Proportion to stores larger than 1,400 sq m*	*Proportion to stores larger than 2,000 sq m*	*Proportion to stores larger than 1,400 sq m*	*Proportion to stores larger than 2,000 sq m*
Asda	93.30	84.27	83.02	71.43
Morrisons	91.60	84.21	82.42	73.68
Sainsbury's	91.45	82.52	80.37	67.35
Somerfield	N/A	N/A	N/A	N/A
Tesco	89.41	78.83	78.42	66.40
Waitrose	86.67	71.43	81.25	66.67

Source: CC analysis.

Notes:
1. We do not report results for Somerfield stores larger than 2,000 sq metres due to the small number of these stores in our sample. Equally, the results for Somerfield stores larger than 1,400 sq metres and for Waitrose stores larger than 1,400 sq metres should be interpreted with caution.
2. N/A = not available.

4.48 Overall, the results show that customers undertaking both large weekly shopping trips and other shopping trips view other stores larger than 1,400 or 2,000 sq metres as the next best alternative to the store larger than 1,400 or 2,000 sq metres in which they are undertaking their existing shopping trip. This analysis provides further

[1]As we set out in paragraph 4.41, large weekly shopping trips are defined as those that account for at least 60 per cent of a household's weekly expenditure on groceries, and 'other' shopping trips are all other shopping trips.

evidence that the main competitive constraint faced by larger stores is other larger stores.[1]

Entry analysis

4.49 Analysing the impact of new store entry on the revenues of existing grocery stores in the same local area allows us to assess the extent to which customers switch from their existing store to another store of the same or different size when new stores become available to them.

4.50 Using data for 2001 to 2006, we assessed how revenues of mid-sized stores and larger stores were affected by entry into the same local area of other mid-sized and larger stores. In analysing the impact of larger stores, we looked at stores sized between 1,400 and 4,000 sq metres, and stores larger than 4,000 sq metres.[2]

4.51 Our analysis (see Table 4.4) shows that for incumbent larger stores, entry by a new larger store within a 5-minute drive-time reduced revenues at the incumbent store by around 7 per cent.[3] Where the new entrant is a mid-sized store, the estimated revenue impact on the incumbent larger store is far smaller at around 1.6 per cent for entry within a 5-minute drive-time.[4] This indicates that customers of larger stores are more willing to switch to other larger stores than to mid-sized stores.

4.52 Looking at incumbent mid-sized stores we find that entry by larger stores affects revenue at the incumbent store by around 15 per cent (where entry occurs within a 5-minute drive-time), but where entry occurs by another mid-sized store, revenue at the incumbent store declines by around 5 per cent. This indicates that customers of mid-sized stores are more likely to substitute to larger stores than to other mid-sized stores when new stores become available to them. (The full results of this analysis are reported in Appendix 4.3.)

[1]Tesco also submitted the results of a simple econometric model of demand, and told us that the model did not support a store size delineation of the product market other than at 280 sq metres. This model, however, suffers from a number of technical shortcomings, and as a result, we do not place any weight on the results of this analysis (see Appendix 4.2).

[2]Entry may have a gradual and sustained impact on incumbent revenue. To allow for this possibility, we estimated the effect in the quarter of entry, as well as in the two quarters following entry. We combine these estimated quarterly effects to give us an estimate of the medium-term effect.

[3]Entry within a 5- to 10-minute drive-time reduced revenues at the incumbent store by around 5 per cent and entry within 10 to 15 minutes by around 2 per cent.

[4]Entry by a store of mid-sized stores (ie 280 to 1,400 sq metres) does not have a statistically significant effect on incumbent larger stores (ie larger than 1,400 sq metres) beyond 5 minutes.

TABLE 4.4 **Revenue impact on incumbent stores from new store entry**

per cent

	Revenue effect on incumbent stores 280–1,400 sq m	*Revenue effect on incumbent stores >1,400 sq m*
Entry of mid-sized store (280–1,400 sq m):		
within 5 minutes' drive-time	**–5.4*** **	**–1.6*** **
within 5–10 minutes' drive-time	**–2.3*** **	–0.27
within 10–15 minutes' drive-time	–0.59	–0.44
within 15–20 minutes' drive-time	–0.38	0.30
Entry of larger store (1,400–4,000 sq m):		
within 5 minutes' drive-time	**–15*** **	**–7.1*** **
within 5–10 minutes' drive-time	–2.1	**–5.1*** **
within 10–15 minutes' drive-time	0.37	**–2.3*** **
within 15–20 minutes' drive-time	–0.31	–0.7
Entry of very large store (>4,000 sq m):		
within 5 minutes' drive-time	**–12*** **	**–11*** **
within 5–10 minutes' drive-time	**–4.4*** **	**–6.9*** **
within 10–15 minutes' drive-time	–0.23	**–2*** **
within 15–20 minutes' drive-time	0.54	–0.24
Store-quarter observations	28,070	21,868

Source: CC analysis.

Note: Medium-term estimates are based on regression coefficients reported in Appendix 4.3. Asterisks indicate that the medium-term estimate is significantly different from zero with the following confidence levels: *90%, **95%, ***99%.

Conclusions on the store size delineation of the product market

4.53 The evidence reviewed in paragraphs 4.43 to 4.48 indicates that consumers do not view all store sizes as perfectly substitutable for one another, and as a result, a hypothetical monopolist could increase prices profitably at a group of grocery stores of a certain size (ie meet the conditions of the hypothetical monopolist test).

4.54 In paragraphs 4.55 to 4.63, we consider the extent to which it might be possible for a hypothetical monopolist to increase prices profitably in each of three different store size groups (ie larger grocery stores, mid-sized grocery stores and convenience stores).

Larger grocery stores

4.55 Some consumers prefer larger grocery stores (ie stores larger than 1,000 to 2,000 sq metres) because of the greater product range, for both grocery and non-grocery products, as well as the associated amenities available at these stores, such as car parking, various food counters and other services. Shopping statistics show that consumers have a significant preference for conducting their large weekly shopping trips at larger stores although they seem relatively indifferent to store size when conducting other shopping trips. The pattern of store size provision by grocery retailers, and its relationship to the stated strategy of each retailer in terms of attracting consumers, is consistent with consumers having preferences for different store sizes for different shopping trips.

4.56 The results from the consumer demand model and the impact of entry on store revenues clearly show that other larger stores are the closest substitute to larger stores. Following a small but significant price increase at a larger store, the vast majority of marginal consumers will switch to another larger store.

4.57 As a result, a hypothetical monopolist could profitably impose a small, but significant price increase at larger stores. That is, we did not find that a sufficient volume of sales would be lost to convenience or mid-sized stores following such a price increase to render it unprofitable.

Mid-sized grocery stores

4.58 If we take mid-sized stores of 280 to 1,000–2,000 sq metres as our starting point, we assess whether a hypothetical monopolist of these stores could profitably impose a small but significant non-transitory price increase. The evidence reviewed in paragraphs 4.49 to 4.52, such as the impact of new store entry on the revenues of incumbent stores, shows that customers of mid-sized stores are more willing to substitute to large stores than other mid-sized stores. Given this, a small but significant price increase by a hypothetical monopolist would be rendered unprofitable, as large stores provide a strong competitive constraint.

4.59 If we expand our candidate product market to include all grocery stores larger than 280 sq metres, it is likely that a hypothetical monopolist could profitably impose a small but significant price increase. Given that around half of all revenues in mid-sized and larger stores are earned from customers conducting a large weekly shop (see paragraph 4.41), the price increase would be profitable, because the loss of revenues from customers switching to convenience stores would be more than offset by the increase in revenues from customers that do not switch.

Convenience stores

4.60 We also examined whether it would be possible for a hypothetical monopolist to impose a small but significant price increase profitably on convenience stores. As we discuss in paragraph 4.27, stores below 280 sq metres have a somewhat different retail offer both in terms of their product offering and their opening hours. However, the products that these stores carry are also, for the most part, available in larger and mid-sized stores. Evidence from the ACS indicates that around 80 per cent of convenience store revenues are earned from groceries and confectionery, tobacco and news (CTN) products.[1] Of the remaining 20 per cent of revenues, nearly three-quarters is earned from non-grocery products, which are also likely to be available, in large part, at mid-sized and larger grocery stores.

4.61 As a result, we do not think that a hypothetical monopolist of convenience stores could profitably impose a small but significant price increase at these stores. The result of this price increase would be a loss of a sufficient volume of sales to stores larger than 280 sq metres such that the price increase would be rendered unprofitable.

4.62 If we expand our candidate product market to include all grocery stores up to, say, 1,000 or 2,000 sq metres, it is unlikely that a hypothetical monopolist of all these stores could profitably impose a small but significant price increase. This is consistent with our findings on mid-sized stores. That is, a sufficient volume of sales would be lost to larger stores such that the price increase would be rendered unprofitable. As a result, the relevant product market for convenience stores includes all other grocery stores.

[1]We note, however, that these estimates are based on a relatively small sample of eight convenience stores.

Summary

4.63 In summary, we find that the product market for the supply of groceries by grocery retailers can be delineated in terms of store size into three separate store size groups. We recognize that any precise threshold separating these three groups will be somewhat arbitrary. However, recognizing this limitation, we find that the product market can be delineated as follows:

- larger grocery stores (ie stores larger than 1,000 to 2,000 sq metres);
- mid-sized stores (ie stores between 280 sq metres and 1,000 to 2,000 sq metres) and larger grocery stores; and
- all grocery stores (ie convenience, mid-sized and larger grocery stores).

Store fascia

4.64 Store fascia is the second of the two observable variables that may capture many aspects of the retail offer of any given store (see paragraph 4.17). Customers can expect to find a different retail offer at each different grocery store fascia. Store fascia can communicate messages to customers about the type of service customers are likely to encounter, the helpfulness of staff, the freshness of products and many other factors. A key component of store fascia, for the purposes of our analysis of the product market, is the message that store fascia indicates to customers regarding the range and type of products that they can, in general, expect to be available in a store bearing that fascia. This is particularly the case in relation to those fascias that provide a limited range of products to customers as part of their business strategy, which is independent of the constraints imposed by store size.

4.65 In considering the extent to which stores operated by different grocery retailers place an effective competitive constraint on each other, such that it warrants including them in the same product market, we discuss below:

- grocery retailers' monitoring of their competitors (see paragraphs 4.66 to 4.68);
- the revenue impact on the stores of different retailers of different competitors entering their local area (see paragraphs 4.69 to 4.73);
- results from our modelling of consumer demand for groceries (see paragraph 4.74); and
- the product range of different categories of grocery retailer (see paragraphs 4.75 to 4.83).

Grocery retailers' monitoring of their competitors

4.66 If two grocery retailers compete for customers (ie customers have a tendency to switch between the two retailers), we might expect them to monitor each other's offerings to ensure that they are best able to attract customers that might consider switching between them. The information that we have on grocery retailers' monitoring activities is that:

(a) Asda monitors prices on a broad range of products at [✂], and a narrower set of products at the [✂];[1]

(b) Morrisons monitors prices at [✂];

(c) Sainsbury's told us that it [✂]; and

(d) Waitrose monitors [✂].

4.67 Tesco told us that it compared prices on around [✂]. Tesco also monitors prices on around [✂]. Tesco also carries out weekly price checks against [✂], monthly checks against [✂] and [✂] others and periodic or quarterly checks against a variety of other grocery retailers, including [✂].

4.68 We discuss monitoring activities further in the context of our review of emails between Asda, Tesco and their suppliers in Appendix 9.1.

Entry analysis

4.69 We examined the extent to which the revenues of incumbent stores are affected by the entry of new stores of different fascias. Where we identified a revenue effect, we think that this may indicate that fascias are substitutes for each other. Variation in the size of the impact across different fascias may also be informative.

4.70 This analysis shows that, in most cases, the entry by new Asda, Morrisons, Sainsbury's, Tesco and Waitrose stores has a negative effect on the revenue of the incumbent stores of these five competing fascias. It also shows that Somerfield and Co-op stores (including both CGL and regional Co-ops) suffer significant revenue losses as a result of entry by Tesco (in the case of CGL), Asda, Sainsbury's and Tesco (in the case of regional Co-ops), and Tesco (in the case of Somerfield). New M&S stores are seen to have a negative revenue impact on incumbent stores owned by Asda, Sainsbury's and Tesco and incumbent M&S stores suffer a negative impact following the entry of an Asda store.

4.71 In general, with the exception of the impact of Lidl's entry on the revenues of Sainsbury's stores, we did not find that entry by LADs stores impacted on other grocery fascias. We note that out of the six fascias whose entry has a negative impact on the revenues of Sainsbury's stores, entry by a Lidl store has the smallest effect. Similarly, with the exception of entry by an Asda store, other grocery fascias do not have a negative impact on the revenue of LADs' stores.[2]

[1] [✂]

[2] We have no observed entry of Iceland or Farmfoods in our dataset, and so cannot use our entry analysis in relation to these two frozen food retailers.

TABLE 4.5 **Rank of significant entry effects, by incumbent fascias**

Incumbent	*Entrant*	*Incumbent*	*Entrant*	*Incumbent*	*Entrant*
Asda	Tesco	Waitrose	Sainsbury's	Lidl	Aldi
	Morrisons*		Asda		Asda
	M&S*		Tesco		
				Netto	Regional Co-op*
Morrisons	Sainsbury's*	M&S	Asda		Asda
	Tesco				Lidl
Tesco	Regional Co-op	Somerfield	Tesco	Aldi	Lidl
	Waitrose				
	Sainsbury's				
	Asda				
	M&S*	CGL	Tesco		
Sainsbury's	Tesco	Regional Co-op	Asda		
	Asda		Sainsbury's		
	Waitrose*		Tesco		
	Morrisons*				
	M&S	Iceland	Asda		
	Lidl		Regional Co-op*		

Source: CC analysis.

*The effect is statistically weak. It is statistically significant on 90 per cent confidence level.

4.72 CGL submitted that it should not be included in the competitor set on the basis of our entry analysis. However, we only had three instances of CGL entry in our dataset. Such a small number of observations will automatically limit any effect of CGL's entry. We therefore do not believe that it is possible to either include or exclude CGL from the relevant market on the basis of our entry analysis alone.

4.73 In addition to our own analysis, M&S submitted an analysis of the impact of new entry by a number of grocery retailers[1] that showed a negative effect on revenues at M&S stores. Revenues at M&S stores were particularly affected by the entry of [✂] stores.

Econometric model of consumer demand

4.74 We are also able to use the econometric model of consumer demand that we describe in paragraphs 4.43 to 4.48, to inform our analysis of the extent to which customers will switch between different fascias, and in particular, the fascias that benefit most from a small but significant change in QRS at a rival fascia. The results of this analysis suggests that the fascias included in our sample (ie Asda, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose) are close competitors to each other for both large weekly shopping trips and other shopping trips. Further details of this analysis are contained in Appendix 4.2.

Product range

4.75 In paragraphs 4.15 to 4.74, we reviewed a considerable amount of evidence that indicates that stores belonging to large grocery retailers should be included in the same product market subject to the store size delineation set out in paragraph 4.53 to 4.63. To the extent that other grocery stores offer customers a full range of grocery products, we think that these stores are effective substitutes for those operated by the large grocery retailers, subject to our size-based delineation of the product

[1]Aldi, Asda, CGL, Iceland, Kwik Save, Lidl, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose.

market. In general terms, this would include stores belonging to regional grocery retailers, symbol group retailers and convenience store operators.

4.76 However, not all grocery stores offer a full range of grocery products. In the following paragraphs we consider, first, arguments put to us concerning the product range offering of M&S and CGL, second, whether LADs and frozen food stores should be included in the same product market as stores operated by large grocery retailers, and finally, whether specialist grocery stores, such as butchers and greengrocers, should be included in the same product market as other grocery stores.

4.77 Waitrose told us that it did not think that M&S carried a sufficient range of products to be regarded as an effective competitor to large grocery retailers. In particular, M&S carries fewer SKUs compared with large grocery retailers in stores of comparable sizes. Nevertheless, M&S does carry the same broad product range as large retailers, but has fewer SKUs within each product category it only stocks own-label products. As a result, we do not believe that M&S should be excluded from the product market because of its product range.[1] Further, our entry analysis, in particular, provides positive grounds for the inclusion of M&S stores in the same product market as stores belonging to other large grocery retailers.

4.78 CGL submitted that its own larger stores do not carry a sufficient product range to be regarded as effective substitutes for larger grocery stores. Having reviewed the evidence provided by CGL, we concluded that the relationship between range and store size for CGL is similar to the relationship between range and store size for Asda, Morrisons and Tesco presented in Figure 4.1.[2]

4.79 We also examined the position of Whole Foods Market given its relatively recent entry into the larger grocery store format with its Whole Foods Market store in Kensington. Whole Foods Market submitted that the quality, range and service of the retail offer at this store, and the responses of competitors, demonstrates that it exerts a competitive constraint on large grocery retailers. In relation to new Whole Foods Market stores,[3] we agree that these stores should be included in the same product market as the stores of large grocery retailers provided that these stores carry a full range of grocery products.

4.80 A number of grocery retailers told us that Aldi, Lidl and Netto (the major LADs in the UK) should be included in the same product market as large grocery retailers. However, the limited number of products carried by LADs stores means that these stores are not close substitutes for similarly-sized stores operated by CGL, M&S, Sainsbury's, Somerfield and Tesco. In particular, we note that Aldi, Lidl and Netto stores typically sell fewer than 1,000 products.[4] In comparison, large grocery retailers generally sell around 5,000 to 10,000 products in stores in the same size range as those operated by LADs (ie 500 to 1,400 sq metres). The results of our entry analysis

[1] [✂]
[2] CGL also submitted two further pieces of evidence that it said supported a finding that CGL stores were not in the same product market as the stores of other large grocery retailers. First, CGL submitted survey results that sought to assess consumer shopping patterns at CGL and other fascias. Among other things, the results of the survey showed that customers shopping at CGL are most likely to divert to [✂], and least likely to divert to the [✂]. We note, however, that the results are based on small sample sizes and do not control for other factors that might influence customers' choice. Second, CGL argued that higher average prices in CGL stores meant that it should be excluded from the relevant product market. However, we note that the key consideration for market definition is the reaction of customers to a price change rather than any comparison of absolute price levels. CGL also submitted the results of another survey that it told us demonstrated that CGL did not constrain competitors in this market as evidenced mainly by its offer on range and price and consumer opinion of CGL's offer. We did not find the evidence provided by CGL, including its submissions on the entry analysis, product range, pricing levels and survey results to be sufficiently persuasive to conclude that CGL stores should not be included in the same product market as stores belonging to other large grocery retailers.
[3] Whole Foods Market told us that it intended to open at least 40 full concept Whole Foods Markets stores in the UK.
[4] Netto told us that [✂].

also show that Aldi, Lidl and Netto stores are not close substitutes for the stores of large grocery retailers (see paragraph 4.71 and Table 4.5).

4.81 As a result, we believe that LADs stores should not be included in the same product market as stores belonging to large grocery retailers when the starting point for a SSNIP test is stores operated by large grocery retailers. However, we believe that LADs stores are constrained by the mid-sized and larger stores of large grocery retailers, and that there is a one-way or asymmetric constraint analogous to that observed in relation to stores of different sizes.

4.82 Similar considerations apply to frozen food stores, which carry a limited range of non-frozen grocery products. Frozen food stores are not close substitutes for the stores of large grocery retailers and should not be included in the same product market when the starting point for a SSNIP test is stores operated by large grocery retailers. Frozen food stores are, however, constrained by the mid-sized and larger stores of large grocery retailers, and that a one-way or asymmetric constraint is present.

4.83 We also examined whether, putting store size considerations to one side, specialist grocery stores such as butchers and greengrocers are sufficiently close substitutes for larger or mid-sized grocery stores that they should be included in the same product market. As with LADs and frozen food stores, we conclude that the limited range available at specialist grocery stores means that these stores are not in the same product market as stores operated by large grocery retailers.[1] We also find that specialist grocery stores are constrained by the mid-sized and larger stores of large grocery retailers, and that a one-way or asymmetric constraint is present.

Conclusion on the fascia-based delineation of the product market

4.84 In conclusion, the product market for the supply of groceries by grocery retailers can be delineated in terms of store fascia as well as by store size. It would be possible for a hypothetical monopolist to impose a small but significant price increase for stores of those fascias offering a full range of grocery products without losing a sufficient volume of sales to stores operated by LADs, frozen food retailers or specialist grocery retailers such that the price increase would be rendered unprofitable.

4.85 Building on the store size delineation of the product market that we set out in paragraph 4.63, we find that:

- larger grocery stores operated by large grocery retailers (including Asda, CGL M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose) are competitively constrained by larger grocery stores operated by other large grocery retailers, regional grocery retailers and symbol group retailers;

- mid-sized grocery stores operated by large grocery retailers are competitively constrained by mid-sized and larger grocery stores operated by other large grocery retailers, regional grocery retailers and symbol group retailers; and

- convenience stores operated by large grocery retailers are competitively constrained by convenience, mid-sized and larger grocery stores operated by other

[1]While customers can only buy a particular type of product from each specialist, it may be possible to buy a range of different products from a 'parade' of specialist grocery stores located near to one another. However, even where such 'parades' of specialist grocery stores exist, we consider that customers at grocery stores operated by a large grocery retailer are not likely to see a collection of specialist grocery stores as a close substitute. This is due to the time associated with visiting a large number of individual shops compared with the convenience of shopping at a single store.

large grocery retailers, regional grocery retailers, symbol group retailers and independent non-affiliated convenience store operators.

4.86 In relation to the LADs, frozen food retailers and specialist grocery stores, we find that:

- LADs stores are competitively constrained by other LADs stores and mid-sized and larger grocery stores operated by large grocery retailers, regional grocery retailers and symbol group retailers;

- frozen food stores are competitively constrained by other frozen food stores and mid-sized and larger grocery stores operated by large grocery retailers, regional grocery retailers and symbol group retailers; and

- specialist grocery stores are competitively constrained by other specialist grocery stores in the same product category (ie butchers are in the same product market as other butchers) and mid-sized and larger grocery stores operated by large grocery retailers, regional grocery retailers and symbol group retailers.

Geographic market

4.87 As with the relevant product market, the hypothetical monopolist 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.

4.88 Demand-side substitution is the key focus in our analysis of market definition (see paragraph 4.7). The willingness of customers to switch to stores in other areas in response to a price increase or a worsening of the retail offer more generally is an important factor in defining the market. As discussed in paragraph 4.10, the starting point for the hypothetical monopolist test can affect the outcome, and this is particularly the case in relation to the geographic market for grocery stores. There will be a degree of overlap between the geographic markets surrounding each store.

4.89 We describe the relevant geographic market for the supply of groceries, particularly in the case of mid-sized and larger stores, in terms of drive-times between competing stores. For the most part, consumers take their car when shopping.[1] It is possible that the proportion of customers driving will decrease in the future given both environmental concerns and changes in shopping habits. However, our analysis is not based on the assumption that everyone uses a car to go shopping far less that everyone should use a car for that purpose; drive-time is simply a useful metric for expressing the size of the relevant geographic market for mid-sized and larger stores and capturing the distance over which competitive constraints operate between stores.

[1]According to recent research, around 36 per cent of customers report driving to an out-of-town supermarket, 25 per cent report driving to a high street shop, and 10 per cent use public transport. Only 16 per cent of customers report that they walk to the shops and use of online shopping is a comparatively small 1 per cent of customers (IGD, *Shopper Trends in Product and Store Choice*, 2007).

4.90 In considering the relevant geographic market for grocery retailing, we discuss below:

- retailers' assessments of the geographic scope of competition (see paragraphs 4.91 to 4.97);
- the scale of national and local competitive initiatives by grocery retailers (see paragraphs 4.98 to 4.101);
- consumer shopping patterns and catchment areas for grocery stores (see paragraphs 4.102 and 4.103);
- a model of consumer demand for groceries (see paragraphs 4.104 and 4.105);
- geographic variations in store-level profit margins (see paragraphs 4.106 to 4.113);
- the impact of new store entry on the revenues of incumbent stores (see paragraphs 4.114 to 4.116);
- a model submitted by Tesco that seeks to simulate the effect of store-level price increases (see paragraphs 4.117 to 4.131); and
- the impact of Internet-based grocery shopping (see paragraphs 4.132 and 4.133).

Retailer assessments of the geographic scope of competition

4.91 We reviewed a number of internal documents from grocery retailers that provided an insight into how these retailers view the geographic scope of competition between different grocery stores. These include:

- market research assessments on the retail offer of individual stores; and
- investment appraisals for new stores.

4.92 Consumer research and benchmarking surveys are regularly undertaken by large grocery retailers. The majority of these consumer surveys focus on local customer typography and how a particular store, or store format, can best meet the expectations of those customers. The benchmarking surveys that we reviewed tend to evaluate national characteristics of competing stores and their fit to a local market. In this way the local competition can be evaluated and the store-level retail offer can be adjusted so as to meet local consumer expectations.

4.93 For example, Asda identified those aspects of its competitors' offer that most effectively resonate with customers in Northern Ireland. A further study evaluated local differences in the competitor set and local factors for its 15 stores (at that time) in Northern Ireland.[1] We reviewed a telephone survey which questions consumers on the importance of local participation and what is expected of local stores to demonstrate that they are part of the local community.[2] Numerous 'listening groups' are held in-store, with an Asda director present, to hear concerns directly from customers which invariably include local competitive conditions.[3]

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[1]Milward Brown Ulster, *Northern Ireland*, May 2005.
[2]Phonebus, *Community,* 7–9 June 2002.
[3]For example, *Gateshead Report*, November 2005.

4.94 These documents are consistent with the submissions of most grocery retailers and others in relation to the definition of the geographic market. Asda, the ACS, Sainsbury's,[1] M&S, Morrisons,[2] Somerfield and Waitrose all told us that the competitive constraints in grocery retailing were local, but a number of these parties also made reference to the presence of national, as well as local, aspects of competition (see paragraphs 4.98 to 4.101).

4.95 Tesco, however, submitted that the geographic market for the supply of groceries was national. Evidence and arguments submitted by Tesco in support of this view include the predominance of national, as opposed to store-level, competitive initiatives by grocery retailers, the national pricing policies of most large grocery retailers, national branding and advertising, and the substantial costs that would be associated with local PQRS strategies. Tesco also submitted that if markets were, contrary to its view, local there were chains of substitution between local geographic markets that widened these markets to at least 30 minutes. It sought to demonstrate this through a simulation model of the hypothetical monopolist test (see paragraphs 4.117 to 4.131),[3] and a study of the link between individual measures of PQRS and local concentration (see Appendix 6.3). Morrisons also argued that there were likely to be chains of substitution between local markets. These were most likely to occur in heavily built-up areas of the UK in which there are no discontinuities in catchment areas.

4.96 Despite these arguments, several of Tesco's internal documents show that, consistent with other retailers, it evaluates the stores operated by competitors in the vicinity of its own stores, indicating that Tesco's internal decisions regarding stores are influenced by its assessment of local competitive constraints.[4]

4.97 Tesco commissions studies to optimize the performance of individual stores. These studies take into account the characteristics and typology of customers in the local catchment area of a store,[5] and typically make comparisons with local competitors.[6] In response to the demands of local customers, Tesco has revised product ranges and store layouts to improve the performance of a store[7] and has developed store-level strategies according to the identity of neighbouring stores.[8] In our view, a prime concern for Tesco would be the potential for customers to switch to alternative stores in the area where Tesco is not successful in meeting local customer preferences. For example, Tesco told us that a review of its new store in [✂] showed that it was underperforming in part because it had underestimated the strength of local

[1]Sainsbury's told us that in addition to local aspects to competition there are national aspects and these interact in the following ways: *(a)* scale economies at the national level can increase barriers to entry at a local level, therefore increasing the areas of high local market share—this may adversely affect consumers at both the national and local level; and *(b)* the greater the proportion of stores an operator has with high levels of local market share, the greater its ability and incentive to raise prices or reduce levels of service, range and/or quality independently of other operators at a national level, or flex its pricing or offer at a local level.
[2]Morrisons told us that whilst the key elements of competition between grocery retailers might manifest themselves in stores competing for customers at a local level, these elements were determined at a national level. In particular, Morrisons noted that the national elements of competition included pricing, purchasing, product range selection, range of own-label products, store format, branding and most advertising, new openings, distribution, in-store marketing and promotions, and service and ethos.
[3]Tesco also submitted that in the event that the relevant geographic markets were local, then its SSNIP simulation model could support the view that they were at least 30-minutes-wide in terms of drive-time.
[4]For example, in Slough, Tesco evaluated the stores operated by its competitors in the vicinity of its own store, and in the context of the proposed redevelopments of its store in Slough, specifically considered the revenue impact of a nearby competitor changing hands. Tesco estimated that the proposed store would take up to [✂] per cent of revenue from its existing store about 800 metres away and this would be the same if [✂] were to occupy the proposed site. [✂]
[5][✂]
[6][✂]
[7][✂]
[8][✂]

competition and the appeal of their food ranges, particularly to upmarket customers.[1] Tesco told us that following the review it planned a number of changes at the store, including increasing the space and range for fresh produce and adding specialist counters to the store.[2] However, other internal Tesco documents, such as research undertaken on the introduction of self-service checkouts and the optimal trolley ratio, do not take account of local competitive conditions.[3]

National and local competitive initiatives by grocery retailers

4.98 As we set out in paragraph 4.95, Tesco submitted that the prevalence of nationally set, and largely uniform, aspects of the retail offer for grocery stores indicates a national rather than a local geographic market.[4] Most retailers set their prices uniformly, or mostly uniformly, across their store network, although CGL and Somerfield both allocate their stores to varying price bands. Various other facets of the retail offer, such as promotions, may also be applied uniformly, or mostly uniformly, across a retailer's store network. Examples of national- and local-level competitive initiatives are provided in paragraphs 6.34 to 6.51.

4.99 However, the fact that certain aspects of the retail offer are predominantly set uniformly on a national basis does not mean that the geographic market is national. Demand-side substitution by customers, which is the key to market definition in grocery retailing, can only take place within a local framework.

4.100 Further, uniform pricing is not necessarily a permanent characteristic of grocery retailing, but a choice made by grocery retailers. CGL and Somerfield price locally and many more retailers did so prior to the 2000 investigation. Grocery retailers can implement systems that charge different prices at stores in different areas. Other facets of the retail offer that are also currently set on a uniform, or near uniform, basis at a national level could similarly be altered so as to provide different offers at different stores.

4.101 A local geographic market does not necessarily require grocery retailers to vary systematically each aspect of their retail offer in each store according to the extent of local competition. A retailer will take account of the extent of local competition faced by its stores when making decisions regarding prices and other competitive variables, even if these are set uniformly across all stores. We discuss this issue in further detail in paragraphs 6.29 to 6.63.

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[1]Tesco told us that customer feedback showed that once it opened, its [✂] store underperformed in part because its food range was smaller than that of several competitors, which was exacerbated by the extension of the Sainsbury's store in [✂] that Tesco had not been aware of when designing the store. The feedback also indicated that fewer customers than expected were travelling to the store by car, that the standard Tesco superstore layout/range was not working in that location and that customers were unclear what the store stood for. Tesco told us that the evidence from customers demonstrated that it had underestimated the strength of the local competition and the appeal of its food ranges, particularly to upmarket customers.
[2]Tesco told us that to improve the store's performance and in response to its customer research, it planned a number of changes to the store to make it more appropriate to the customers in the area, including increasing the space and the range of fresh produce, adding specialist counters, highlighting upmarket ranges more effectively (a strategy that Tesco subsequently told us was part of a national plan), reducing the space for snacking lines and relocating them, and altering the layout of the store to ensure that its two entrances both look like a food shop. Finally, Tesco decided that it had overestimated the degree of car-borne trade and the impact of compromised car parks on its competitors in this type of location. Tesco submitted that these were small variations, and contended that the number and extent of those variations that it applies locally is very limited.
[3]*Research Debrief: Self-Service Checkouts*, Simpson Carpenter, October 2005, and *Trolley Ratio Research Findings*, Marketing Sciences, October 2005.
[4]While these aspects of the retail offer are set centrally they are not necessarily all the same at all stores. For example, Tesco and Sainsbury's both charge different prices at some of their stores. Tesco charges higher prices at all of its Express stores [✂] and Sainsbury's charges higher prices for some of its products at its smaller stores. Tesco and Sainsbury's told us that these higher prices reflected the higher operating costs at these stores.

Consumer shopping patterns and store catchment areas

4.102 A catchment area is the area from which a store draws most of its customers. Table 4.6 shows that most customers shop locally. While the majority of consumers shop in convenience stores located within a 5-minute drive-time, most consumers will travel between 10 and 15 minutes to get to a mid-sized or larger grocery store. Our analysis shows that the catchment area of convenience stores is smaller than that of mid-sized stores, which, in turn, is smaller than the catchment area of larger stores. In terms of market definition, this implies that following a price increase the marginal customers of a convenience store would either switch to nearby convenience stores or travel a greater distance to shop at competitor's mid-sized stores or even further to shop at larger stores.[1]

TABLE 4.6 **Cumulative distribution of customer drive-times (cumulative % of customers)**

per cent

	Drive-time (mins)					
	Up to 5 mins	*Up to 10 mins*	*Up to 15 mins*	*Up to 20 mins*	*Up to 25 mins*	*More than 25 mins*
*Total expenditure**						
Stores below 280 sq m	64.53	89.48	94.03	96.99	97.07	100.00
Stores between 280 and 1,000 sq m	56.37	79.12	91.50	96.98	98.39	100.00
Stores above 1,000 sq m	21.55	58.51	80.99	92.32	96.61	100.00
All shopping trips†						
Stores below 280 sq m	73.91	91.54	95.81	99.04	99.21	100.00
Stores between 280 and 1,000 sq m	57.83	81.39	91.57	97.23	98.84	100.00
Stores above 1,000 sq m	28.33	65.42	84.69	94.16	97.44	100.00

Source: CC analysis of TNS SuperPanel data.

*The percentage of all shopping trips that take place at a particular size of a store within a particular size of the catchment area.
†The percentage of all shopping trips that take place at a particular size of a store within a particular size of the catchment area.

4.103 Table 4.6 shows that a majority of consumers (more than 80 per cent) shop at large stores within a 15-minute drive-time and that a similar proportion of consumers shop at medium-sized stores within a 10-minute drive-time. Table 4.6 also shows that more than 64 per cent of consumers visit convenience stores within a 5-minute drive-time. According to the results of the convenience tracker programme carried out by market researcher company 'him!', a similar proportion of consumers (62 per cent) live within half a mile of a convenience store (see Table 4.7). These results are consistent with evidence from [✂] chain of smaller stores operates a rule of thumb for the extent of its catchment area based on a half-mile radius.

[1]Catchment areas show how far consumers are likely to travel to reach a store, but should not be read as directly corresponding to the size of geographic markets. Catchment areas can be wider or narrower than the relevant geographic market, which is defined by the location of competitor stores, not the location of customers. It is the extent of the overlap in catchment areas that is of interest to us for the purposes of market definition, because customers in the overlap are more likely to switch to competing stores (ie they are more likely to be marginal).

TABLE 4.7 **Proportion of consumers living within different distances from convenience stores**

Cumulative distance bands	*Cumulative percentages of consumers*
Up to 100 yards	21
Up to ¼ of a mile	48
Up to ½ a mile	62
Up to 1 mile	76
Up to 2 miles	84
Up to 5 miles	92
Up to 10 miles	96
More than 10 miles	100

Source: him!, Convenience tracking programme, spring 2007.

Econometric model of consumer demand

4.104 The econometric model of consumer demand that we discuss in relation to the product market (see paragraphs 4.43 to 4.48 and paragraph 4.74) can also be used to assess the extent to which grocery stores will lose customers to other local grocery stores following a small but significant worsening in the retail offer.

4.105 The results show that the stores most likely to benefit from a deterioration of the retail offer at a competitor store are those that are located nearby. Competitor stores located more than 10 minutes' drive-time away will benefit much less than those that are located within 10 minutes' drive-time. Looking at differences according to the type of shopping trip, the results are similar for households doing large weekly shopping trips and for those doing other shopping trips. However, households doing other shopping trips are less likely to switch to stores located further away following deterioration in the retail offer.

Geographic variation in store-level margins

4.106 If the relevant geographic market were national, we would not expect store profit margins to vary with local conditions. However, if grocery retailers compete locally we may observe a relationship between store profit margins and local competitive conditions. Once a grocery retailer has opened a store in a local area, it competes on those aspects of the retail offer that it can change relatively easily in the short run. When consumers in a local area have a limited choice of alternative grocery stores, or none at all, grocery stores may provide a poorer retail offer in the form of higher prices, lower-quality product and service, and a poorer range of products. In this case, where the store faces limited local competition it will achieve a higher profit margin. On the other hand, when consumers have a large choice of grocery stores in the local area, grocery stores need to provide a high-quality retail offer to consumers. Otherwise, consumers will respond by switching to other stores that provide a better offer within the locality. As a result, any differentials in profit margins across a local area that are associated with a different level of competition are evidence of the presence of local markets.[1]

4.107 Although most large grocery retailers set prices centrally and uniformly, or nearly uniformly, for all their stores, there is evidence that they vary some parts of the retail

[1]In this case, we are examining the competitive constraints between stores directly rather than using an assessment of consumer willingness to substitute between stores to inform us about competitive constraints.

offer according to local competition. We provide examples of store-level variations in the retail offer in paragraphs 6.36 to 6.46.

4.108 Tesco told us that it did not vary any part of its retail offer with local competition. In support of this argument, Tesco submitted an analysis of various individual components of its retail offer, including price, range, stock availability and checkout waiting times in stores larger than 1,400 sq metres, which found no statistically significant relationship between local concentration and those components of its retail offer (see Appendix 6.3).[1] However, a store's retail offer is extremely difficult to measure and reflects the cumulative effect of various actions by the retailer. We do not believe that Tesco's analysis adequately captures all the different facets of the retail offer, and we have further methodological concerns (see paragraphs 6.47 to 6.51). For these reasons, we place only limited weight on the results of this analysis.

4.109 We think that our own analysis of store profit margins better captures the variation in the retail offer between stores. In a more competitive environment, effort in keeping store cleanliness to a high standard, maintaining store service quality, ensuring the freshness of fruit and vegetable products, and supplying a broad range of products will all lead to higher store costs and lower store profits. Alternatively, a store facing little local competition will not need to engage in 'extra' activities to attract customers. Fewer vouchering campaigns, less attention to stock and a reduced range of products are, for example, the result of a less competitive environment. The more particular the activity is to the local market, the less easy it will be to identify systematic variation in individual aspects of the retail offer. However, if such variation does have an effect, it will show up in the store profit margin.

4.110 Our empirical analysis of store profit margins provides evidence that high levels of local concentration result in higher store profit margins, suggesting that competition between grocery stores is essentially local. The results show that under a number of different models store profit margins decline as the number of competing fascias within 10 minutes' drive-time of a store increases.

4.111 The results of this analysis also show that the competitive effect of an additional fascia (as opposed to store) differs considerably depending on how many fascias are already present in the local area. The effect of an additional fascia on the profit margin of an incumbent store declines as the number of competing fascias in the local area increases.

4.112 A related analysis also shows that the distance to a competitor store affects store profit margins. The further away the competing store, the smaller the impact it has on a store's profit margin. The full results of our analysis are set out in Appendix 4.4.

4.113 We discuss our analysis of store-level profit margins further in the context of our competition analysis in paragraphs 6.52 to 6.59.

Revenue impact of new store entry

4.114 We set out our analysis of the way in which the opening of a new store affects the revenues of an incumbent store in terms of different store sizes in paragraphs 4.49 to 4.52 and in terms of different fascia in paragraphs 4.69 to 4.713. We also examined how the revenue impact on incumbent stores of new store entry varies with the distance between the new store and the incumbent store. This enabled us to assess

[1]In addition to the eight individual measures of the retail offer, Tesco also analysed the relationship between results of its store mystery shopper test and local competitive conditions. See Appendix 6.3 for details.

the extent to which customers switch from their existing store to another more distant store when a new store opens.

4.115 Figure 4.9 shows that the revenue impact of new entry decreases with the distance that a new store is located from the incumbent store. The most substantial revenue effects are observed when a store is opened within a 5-minute drive-time and decrease with each 5-minute interval. We do not observe a statistically significant effect beyond 5 to 10 minutes in the case of entry by a mid-sized store, and beyond 10 to 15 minutes in the case of new entry by a larger store.[1]

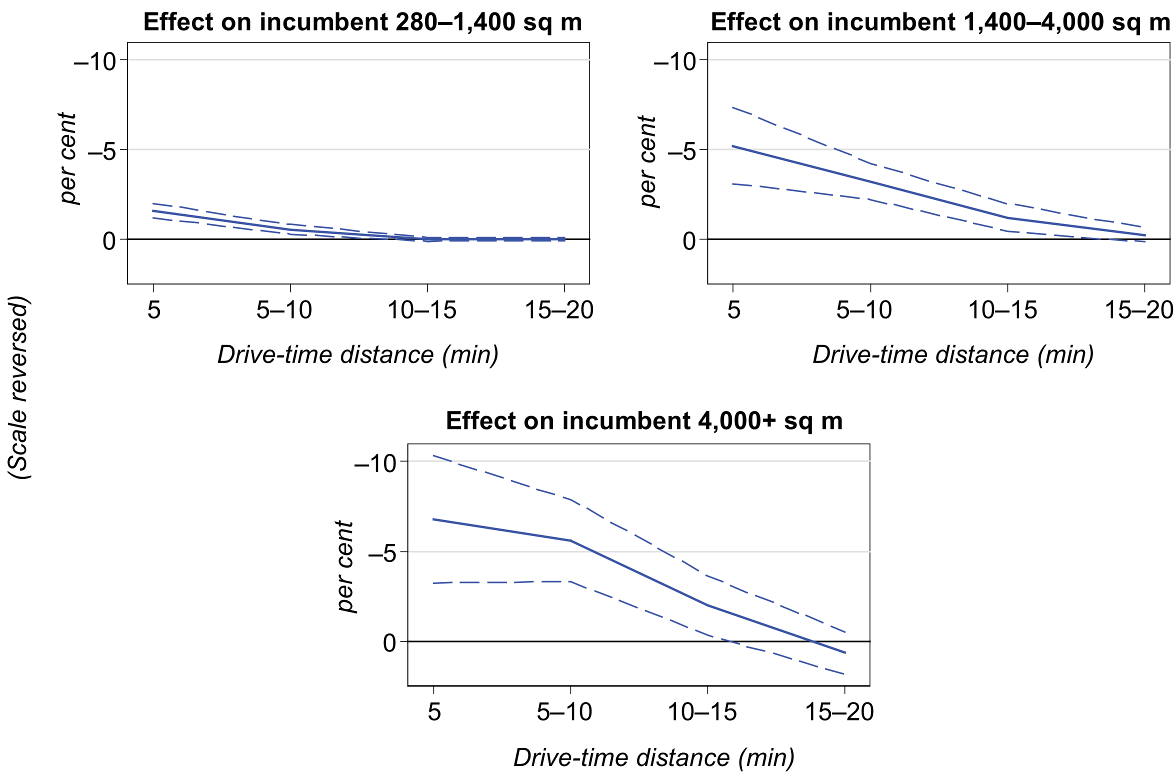
4.116 Figure 4.9 also takes account of size so that the revenue impact only relates to the distance between the incumbent and entrant store.[2] We find that entry by a store of equal size within 5 minutes of a mid-sized incumbent store reduces revenues by around 1.6 per cent, while entry by larger stores reduces revenues at incumbent stores by around 5 to 7 per cent. This effect decreases with distance, such that there is no statistically significant effect when entry takes place beyond 15 minutes' drive-time from the incumbent store. This indicates that customers are more willing to substitute to nearby stores. The full results of this analysis are reported in Appendix 4.3.

[1]The results discussed here, and the results discussed in paragraph 4.51, are based on different specifications of our entry model. For this reason, we do not consider it appropriate to compare the economic significance of the coefficients.

[2]Our entry analysis of the impact of store size differed from our entry analysis of the impact of distance. The analysis of store size focused on the impact of store entry between different size groups. The analysis of distance controlled for store size differences within different size groups to distil the distance impact of entry. The two analyses required different specification and the results therefore have a different magnitude.

FIGURE 4.9

Medium-term revenue impact of entry by a new store of equal size to the incumbent store



Source: CC analysis.
Notes:
1. Analysis uses data for incumbent stores with a net sales area larger than 280 sq metres.
2. Dashed lines represent a 95 per cent confidence interval around the estimated value.

Simulation model of the SSNIP test

4.117 Tesco submitted that chains of substitution between local markets were sufficiently strong to form a national market for grocery retailing.[1] We think that a chain of substitution is unlikely to widen geographic markets beyond local areas for the following reasons. First, the hypothetical monopolist test does not imply that prices at all stores in the candidate market must be increased uniformly allowing any customers lost through a price increase at one store to be captured by another store within the same locality.[2] Second, the chain of substitution breaks down when there is a discontinuity in catchment areas. Finally, even if there are no obvious discontinuities the chain of substitution fades with distance. This is because as the geographic market expands, the number of infra-marginal consumers will increase more relative to the number of

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[1]In support of its arguments, Tesco provided maps based on loyalty card data to suggest that the catchment areas of local Tesco stores overlap to the extent that they are joined up across the country. It also argued that since customers travelled in both directions, they could easily access stores up to twice the catchment area of any individual store. Tesco also provided evidence of the number of customers living within 5 minutes' drive-time of the edge of a 10-minute isochrone and the number of stores reachable within 5 minutes outside that isochrone. Tesco told us that there were typically a larger number of customers living close to the edge of one store's catchment who could easily shop at several stores outside the catchment, indicating that the market was typically wider than an individual store's catchment. In paragraph 4.117 we explain why we think that chains of substitution break and why we do not think that the evidence submitted by Tesco supports a wider geographic market definition.

[2]It is plausible that a hypothetical monopolist of two stores, A and B, could exercise market power by only increasing the prices of store A and not store B. By doing so, store B captures the lost revenues from consumers diverting away from store A, and store C does not act as a constraint on the monopolist. This breaks the chain of substitution.

marginal consumers. As the number of stores under the control of the hypothetical monopolist increases, some of those consumers that were marginal in previous iterations of the test become infra-marginal. As a result, the effect of the chain of substitution is smaller and smaller.

4.118 Tesco submitted a quantitative model that seeks to simulate the impact of a 5 per cent increase in prices at a grocery store (or group of stores), the consequent shift of customers to other stores, and thus the impact on sales volumes on the store(s) increasing prices. This then allows an assessment to be made as to whether the price increase would be profitable, and thus whether the conditions of the hypothetical monopolist test have been met (see paragraphs 4.6 to 4.14).[1] Tesco told us that this simulation model, by demonstrating the existence of a chain of substitution, supported its argument for a national market. Tesco also told us that if markets were to be defined locally, its model directly informed the appropriate size of the local markets, and showed that those markets were not uniform in size and that the majority were wider than 30 minutes' drive-time.

4.119 As with any quantitative model, Tesco's simulation model makes a number of simplifying assumptions regarding the behaviour of consumers and retailers. Tesco includes stores larger than 1,400 sq metres in its model and assumes that each of these stores earns a gross profit margin equivalent to the average margin earned by Tesco at its stores of this size. Consumers are modelled not individually but in groups at the Census Output Area (COA) level. (These are groups of approximately 100 households.) In the base case, each COA is assumed to shop at its nearest grocery store before the price increase.

4.120 Following a price increase, consumers are assumed to switch to a new store provided that the cost of travelling to, and shopping at, the new store is less than the cost of shopping at the store that increased prices. For the purposes of making this calculation, Tesco's model assumes that all consumers, regardless of income, face the same cost of travel.[2] The model also assumes that each COA has a distribution of shopping expenditure that is the same as the national distribution. (For example, 7.2 per cent of each COA will spend £45 to £50 weekly on main grocery shopping trips.) We think that some of these assumptions are problematic for the reasons set out in paragraphs 4.121 to 4.131.

4.121 The uniformity of Tesco's modelling assumptions results in significant customer movements when the effect of a price increase is assessed. In some cases, it results in stores losing all of their customers, and in other cases, it results in stores more than doubling their customer numbers. We believe that neither of these outcomes would be sustainable or realistic in practice.[3]

4.122 As a result, it seems to us that this simulation model is not based on realistic customer switching behaviour. The customer switching behaviour in response to a

[1] Simulation models differ from econometric models in that an econometric model will analyse actual consumer behaviour, while a simulation model will use assumptions about consumer behaviour (that may themselves be derived from an econometric model) to predict consumer behaviour. The value of the simulation model will therefore depend on the extent to which its assumptions about consumer behaviour are robust and sufficiently fine tuned so as to reflect likely behaviour in the future.

[2] Tesco uses an estimate of the cost of travel obtained from analysis of TNS Superpanel data on the store choice of actual grocery shoppers. We have concerns regarding that estimate (see Appendix 4.5).

[3] Tesco submitted that the assumption that customers cared only about distance and price meant that when stores were very close together, the model would tend to predict significant levels of switching following a price increase. Tesco told us that this did not bias the overall result of the model, since stores that were close together would typically lie within the same geographic market. Tesco also submitted an extension to its base model which it told us took account of customer and store heterogeneity. It told us that the extension improved the accuracy of the switching predictions and did not significantly affect the size of the geographic markets. For the reasons discussed in Appendix 4.5, we have a number of concerns about Tesco's extension to the model.

5 per cent price increase in Tesco's model is not estimated from observations of actual consumer behaviour but it is simulated based on a number of simplifying assumptions. We therefore have concerns about the ability of the simulation model provided by Tesco to provide useful insights into actual consumer shopping behaviour. We do not doubt the need for simplifying assumptions in any modelling exercise. However, we are concerned that the abstraction from actual customer behaviour and the simplifying assumptions in this simulation model are such that its ability to provide useful insights into consumer behaviour when faced with a price increase is limited.

4.123 Putting to one side our concerns regarding the abstraction from actual consumer behaviour in the Tesco simulation model, we also have some concerns about two other significant assumptions. First, Tesco assumes a uniform 5 per cent price increase across different stores within the area controlled by the hypothetical monopolist. In a market where the location of grocery stores constitutes an element of differentiation for consumers, it is not clear that a profit-maximizing hypothetical monopolist would increase prices uniformly at all stores. Second, Tesco assumes that all stores are homogenous, that is, they provide an identical retail offer, which makes consumers indifferent as to the choice between them other than in terms of prices and location. We assessed the sensitivity of the model to these two assumptions.[1]

4.124 The Tesco model, when implementing a price increase as part of the SSNIP test, assumes that the hypothetical monopolist increases prices by 5 per cent at each of the stores under its control. However, the hypothetical monopolist could increase prices by 5 per cent, on average, by increasing prices at some stores by more than 5 per cent and in other stores by less than 5 per cent (a practice referred to as price flexing).[2]

4.125 In principle, a profit-maximizing hypothetical monopolist will have an incentive to increase prices differently at different stores (ie price flexing). The hypothetical monopolist has a strong incentive to raise prices at stores that face little competition from stores outside its control. However, for stores that face competition from stores outside its control, the hypothetical monopolist's incentive to raise prices is weaker. For the purposes of the hypothetical monopolist test, we consider it appropriate to assume that a hypothetical monopolist would engage in price flexing as this is the strategy that would allow it to maximize profits.

4.126 Tesco told us that, as grocery retailers had uniform national pricing, we should not consider the possibility of price flexing as part of the hypothetical monopolist test. We do not agree with this view. First, the hypothetical monopolist test is a hypothetical exercise. As a result, it is by no means clear that the current pricing practices of grocery retailers, which could in practice be changed (see paragraph 6.31), should be used as part of the test.

4.127 Second, the hypothetical monopolist, by increasing prices in the candidate market, is engaging in price flexing relative to stores that it controls outside the candidate

[1]In addition, the Tesco model begins with all the stores that lie within a 10-minute drive-time (or isochrone) of a Tesco store. For each iteration of the test, Tesco expands the geographic market in 5-minute increments to include additional stores larger than 1,400 sq metres in the candidate market. In our analysis, rather than expanding the market in 5-minute increment isochrones, we add one store at a time to the candidate market. Each time the SSNIP test fails, we expand the candidate market by including the closest substitute store to the hypothetical monopolist. We think this is a closer approximation of the SSNIP test. In Appendix 4.5 we also discuss our concerns regarding other assumptions in this model. Tesco told us that expanding the market in 1-minute increments or one store at a time made little difference to the results of the model.
[2]As discussed in paragraph 4.11, a price increase of less than 5 per cent may be appropriate when applying the hypothetical monopolist test to the supply of groceries.

market. As a result, we do not see that a distinction should be drawn between the stores that the hypothetical monopolist controls inside the candidate market, and any stores that it controls outside the candidate market.

4.128 Finally, the real world pricing practices of grocery retailers are not as clear-cut as suggested by the arguments that have been put to us. Most grocery retailers operate multiple price files that reflect different fascias, store formats, and in some cases, competitive conditions (see paragraph 6.31).

4.129 The second assumption that we vary in our analysis is Tesco's homogeneity assumption. This is the assumption that all stores are equal substitutes (ie all stores are equivalent in the eyes of customers and their choice between them will be purely driven by the price they charge and their location). In subsequent submissions, Tesco has tested this assumption by allowing 30 per cent of consumers to remain loyal to their local store even after a price increase. Tesco reports that adopting this revised assumption results in 81 per cent of urban stores and 71 per cent of rural stores failing the SSNIP test at 30 minutes.

4.130 We also relaxed the homogeneity assumption, using Tesco's own sensitivity test (ie 30 per cent of customers remain loyal following a price increase), and combined this with a relaxation of the uniform price increase assumption.[1] Specifically, in each area where we reassessed the local geographic market using Tesco's simulation model, we first relaxed the uniform price increase assumption, and second relaxed both the uniform price increase assumption and the homogenous store assumption. Using these revised assumptions, we analysed 20 geographic areas and found that, according to Tesco's model, the relevant geographic market extends from 5 to 25 minutes. Full results of our analysis are contained in Appendix 4.5.

4.131 While we note that these revisions to the Tesco simulation model produce results that are consistent with other evidence on the size of the geographic market for grocery retailing, we have sufficiently serious concerns regarding this model that we place limited weight on this outcome.

The impact of Internet-based grocery shopping

4.132 Internet shopping for groceries constitutes around 1 to 2 per cent of UK retail grocery sales. This seems likely to increase in the future although the extent of any increase is not clear.[2] It is plausible that the emergence of Internet shopping may widen the geographic market for grocery shopping:

(a) Tesco told us that, as at September 2007, 98 per cent of the population could receive deliveries from Tesco.com, 55 per cent from Ocado, 81 per cent from Sainsbury's to You and 63 per cent from Asda at Home.

(b) Online retailers typically deliver up to 30 minutes or more from the store.

(c) Some Internet retailers (eg Ocado) do not base their delivery service around particular stores. In such cases, the catchment area of the service is decoupled

[1]Tesco later submitted a revised assumption that it believed was a better model of store differentiation. As noted in Appendix 4.5, we consider that this revised assumption lacks a number of features that Tesco's initial assumption captured. For that reason, it does not add to our understanding of the effect of customer loyalty and switching costs on geographic market definition.

[2]IGD predicts that this part of the grocery market will continue to grow faster than any other grocery sector in the period until 2011.

from store location and replaced by the geographical coverage that can be provided by deliveries from warehouses.

4.133 Should Internet shopping become substantially more important than today, it may alter our assessment of the relevant geographic market. However, in terms of demand-side substitution, the size of Internet shopping is sufficiently small today that few customers can view it as a ready alternative to shopping at local grocery stores. In terms of supply-side substitution, a rapid and immediate expansion of grocery Internet shopping following a small but significant price increase also appears unlikely. Any operator would have to incur adjustment costs that would slow down such expansion. As a result, we do not believe that the availability of Internet-based shopping currently affects the definition of the geographic market. The relatively small share that Internet-based grocery shopping is estimated to achieve in the coming years indicates that this situation is unlikely to change in the near future.

Conclusions on geographic market

4.134 In conclusion, we considered a wide variety of evidence in assessing the scope of the relevant geographic market for grocery retailing. This includes retailers' own assessments of the geographic scope of competition, consumer shopping patterns and store catchment areas, an econometric analysis of consumer demand, geographic variations in store profit margins, and the impact of new store entry over varying distances on the revenues of incumbent stores. We also reviewed a model that seeks to simulate the impact of store-level price increases although we place limited weight on the outcomes from this model. We find that the evidence indicates that the geographic scope of competition in grocery retailing is fundamentally local. In the following paragraphs we bring together our findings on both the product and geographic market.

Conclusions on the relevant markets for the supply of groceries by grocery retailers

4.135 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 (ie stores larger than 1,000 to 2,000 sq metres) are in the same product market;

(b) for mid-sized stores, other mid-sized and larger grocery stores are in the same product market (ie all stores larger than 280 sq metres); and

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

4.136 There are several important qualifications to these basic categorizations. The precise delineation of the product market differs across local geographic markets. The threshold for inclusion in the relevant product market varies across local markets depending on the distribution of stores of different sizes in each local market, and factors such as store amenities, opening hours and other facets of the retail offer. It is necessary to take into account the nature of the retail offer by different stores in each local market when assessing the stores that should be included in the product market locally.

4.137 In relation to the mid-sized and larger grocery stores product market, stores may be more or less competitive depending on their relative size, and there may also be local markets where stores smaller than 280 sq metres place a competitive constraint on stores larger than 280 sq metres. While these local variations are important, we need to apply more precise size thresholds to analyse collectively a large number of local markets. For this purpose, we decided that a lower-size threshold of 280 sq metres for mid-sized stores is appropriate.

4.138 Similarly, in relation to the larger grocery stores product market, local conditions will affect the lower size threshold for larger stores that place a competitive constraint on other larger stores. For the purpose of analysing collectively a large number of local markets, we have in many cases used a 1,400 sq metre threshold, which we found to be a useful approximate mid-point between the 1,000 to 2,000 sq metre range that we identify in paragraph 4.135. We note that a 1,400 sq metre threshold has been used in previous CC inquiries in the groceries sector.

4.139 In terms of store fascia, in each local market, a store operated by any of the large or regional grocery retailers and symbol groups (ie with the exception of stores operated by LADs and frozen food retailers) is in the same product market as stores operated by any of the other large or regional grocery retailers and symbol groups—provided that the store in question meets the local store-size threshold for inclusion in the product market. In individual local markets, particularly the all grocery stores product market, there will be independent non-affiliated convenience stores in addition to those operated by large, regional or symbol group retailers that should be included in the relevant product market for the purposes of undertaking a competition analysis.

4.140 In summary, 90 to 95 per cent of all larger grocery stores are operated by eight large grocery retailers, namely Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. The remaining larger grocery stores are operated by symbol groups, such as Budgens, Costcutter, Nisa-Today's and Spar, and regional grocery retailers, such as the regional Co-ops, Dunnes and Proudfoot (see paragraphs 3.7 and 3.8).

4.141 Somerfield (827 stores) is the grocery retailer with the largest number of stores in the mid-sized and larger grocery stores product market followed by Tesco (728 stores), Sainsbury's (492 stores) and CGL (485 stores). Asda, M&S and Morrisons each have between 300 and 400 stores larger than 280 sq metres. For Asda, Morrisons, Sainsbury's, Tesco and Waitrose, the majority of their stores competing in the mid-sized and larger grocery stores product market are larger grocery stores.

4.142 In terms of the all grocery stores product market, this includes—in addition to the stores identified in the previous two product markets—convenience stores operated by large grocery retailers, regional grocery retailers, symbol group retailers, and independent non-affiliated convenience store operators. We provide details of convenience store operators in paragraphs 3.10 and 3.11.

4.143 In relation to LADs, the product market including these stores will also include those fascias providing a full product range. That is, LAD stores will be constrained by the stores of large, regional and symbol group grocery retailers, but not vice versa. This is also the case for frozen food retailers as well as specialist grocery retailers.

4.144 The geographic market for the supply of groceries by grocery retailers is local. We note that large grocery retailers set significant elements of their retail offer, such as prices, uniformly, or near uniformly, over large numbers of their stores nationwide. In some cases it will be more efficient for a grocery retailer to set prices or other elements of their retail offer uniformly, or almost uniformly, across different local markets and in other cases it is more efficient for a grocery retailer to set aspects of its retail offer according to local competitive conditions. However, in setting those elements of their retail offer that are applied uniformly, or near uniformly, across their stores, grocery retailers take into account the extent to which they face competition, and the identity of their competitors, in different local markets.

4.145 More specifically, in relation to the three product markets that we have 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 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 stores within a 5- to 10-minute drive-time and by larger grocery stores within a 10- to 15-minute drive-time.

4.146 The precise delineation of the geographic market for the supply of groceries by grocery retailers will vary across local markets according to local topographic and other conditions. For the purposes of collectively analysing a large number of local markets, however, we used a threshold of either 10 or 15 minutes as appropriate.

5. Competition between grocery retailers in the supply of groceries

5.1 In this section, and the following three sections of this report, we assess competition between grocery retailers using the framework provided by our definition of the relevant product and geographic markets in Section 4. In doing so, we examine whether there may be any features of the various markets in which grocery retailers compete that prevent, restrict or distort competition in connection with the supply of groceries to consumers and thus give rise to an AEC.

5.2 This section examines whether there are features of the all-grocery-stores product market which prevent, restrict or distort in competition between large grocery retailers and other grocery retailers, particularly independent non-affiliated convenience store operators and symbol group reatilers. The following three sections of the report discuss other aspects of competition between grocery retailers, specifically:

- the extent of concentration in local markets for grocery retailing and its impact on the retail offer (Section 6);
- barriers to entry and expansion in grocery retailing (Section 7); and
- possible coordination between grocery retailers (Section 8).

Potential distortions in competition between large grocery retailers and other grocery retailers

5.3 First, we reviewed two pieces of analysis relevant to whether distortions in competition between large grocery retailers and other grocery retailers might be present, namely:

(a) trends in convenience store numbers and revenues (see paragraphs 5.5 to 5.11); and

(b) an analysis of the impact of entry by larger grocery stores and new convenience stores owned by large grocery retailers on the number of independent non-affiliated and symbol group convenience stores and specialist grocery stores in the locality of these new stores (see paragraphs 5.12 to 5.18).

5.4 Second, we reviewed five potential sources of distortion in competition between large grocery retailers and other grocery retailers, namely:

- a 'waterbed effect' whereby the lower prices that large grocery retailers extract from suppliers result in higher prices for other grocery retailers and wholesalers (see paragraphs 5.19 to 5.43);

- a 'tipping point' in the financial viability of the grocery wholesaler sector (see paragraphs 5.44 to 5.51);

- the impact on convenience store operators, and specialist grocery retailers, of below-cost selling by large grocery retailers (see paragraphs 5.52 to 5.69);

- the impact on convenience store operators, and other grocery retailers, of local vouchering by large grocery retailers (see paragraphs 5.70 to 5.87); and

- recent expansion by Sainsbury's and Tesco in convenience store retailing (see paragraphs 5.88 to 5.98).[1]

Trends in convenience store numbers and revenues

5.5 A number of parties told us that there had been a decline in the number of convenience stores, particularly independent non-affiliated convenience stores, over recent years and said that this was evidence of a feature that was restricting, preventing or distorting competition between large grocery retailers and other grocery retailers. Our view, however, based on a review of ONS data, is that the number of convenience stores has increased slightly since 2003 although the number of independent non-affiliated convenience stores has declined.

5.6 ONS grocery store data[2]—adjusted to remove stores greater than 280 sq metres—showed an increase in the number of convenience stores from around 33,394 in 2003 to 35,505 in 2007 (see Appendix 5.1).[3] We also used ONS data to review trends in the number of convenience stores with fewer than ten staff. The number of these convenience stores increased by 3 per cent from 2003 to 2007 and the number of businesses operating convenience stores grew by around 8 per cent over the same period.[4]

[1]While we found that grocery retailers compete in local markets (see paragraphs 4.134 to 4.146), our analysis of potential distortions in competition is not focused on individual local markets, but rather on market structure or behaviour that potentially distorts competition between large grocery retailers and other grocery retailers across many, or all, local markets.
[2]This corresponds to the SIC 52.11 classification of retail sale in non-specialized stores with food, beverages or tobacco predominating.
[3]ONS, IDBR data—from *UK Business: Activity, Size and Location 2004–2007*, with the same criteria applied to unpublished data from earlier years. The IGD supplied data on the number of large stores greater than 280 sq metres from its series of publications now referred to as *UK Grocery Outlook*. The differences between the numbers of convenience stores in ONS statistics compared with IGD data are set out in Appendix 5.1. In particular, stores that sell groceries in addition to a primary retail classification or without a fixed address (eg petrol station forecourts, food halls within other stores and market stalls or roadside pitches) will be excluded from the ONS total. We note that the ONS compiles data on the number of stores in the food sector in aggregate and cannot separate its database into the various classifications used by other data providers, such as IGD, when measuring the number of stores in the sector.
[4]ONS measures both the number of stores and the number of businesses that operate stores. In many instances, a business will operate multiple stores.

5.7 We also examined data published by IGD that showed a decline in overall convenience store numbers.[1] Unlike ONS data, this is not collected for the purpose of identifying trends in overall convenience store numbers. The overall number of convenience stores reported each year is influenced by changes in classifications, and improvements in data collection since 2000 have also resulted in the removal of duplicate records. These factors limit the comparability of yearly figures. We therefore placed less weight on the IGD dataset than on the ONS data.

5.8 IGD data also showed a decline in the number of independent non-affiliated convenience stores between 2000 and 2007. While we have noted the difficulties associated with making year-on-year comparisons using this data, the decline in independent non-affiliated convenience stores is consistent with our analysis of the grocery wholesale sector (see Appendix 5.5). This showed a decline in return on capital employed for cash-and-carry wholesalers, while return on capital employed for delivered wholesalers had remained stable (see paragraph 5.46). We discuss convenience store numbers in more detail in Appendix 5.1.

5.9 Convenience store revenues, as opposed to store numbers, provide an alternative means of assessing the state of the convenience store sector. IGD reported that convenience store sales have been growing faster than total grocery sales. In 2007, convenience store sales grew by 4.9 per cent to £26.1 billion compared with 4.0 per cent growth in total grocery sales.[2] The IGD also reported that the convenience sector grew faster than mainstream grocery retailing by 0.7 percentage points in 2005 and 1.0 percentage point in 2006.[3]

5.10 We looked at whether the trends in aggregate data for both convenience store numbers and revenues could be explained by an expansion by Sainsbury's and Tesco in the convenience store sector and a decline by other convenience store operators. In terms of store numbers, much of Sainsbury's and Tesco's growth in convenience store retailing has been through acquisition of existing convenience store chains (see paragraph 5.88 for further discussion of acquisitions by Sainsbury's and Tesco in the convenience store sector since 2000). As a result, it is unlikely that their expansion in the convenience store sector masks a decline in the total number of convenience stores operated by other grocery retailers. In terms of revenues, Sainsbury's and Tesco's expansion in convenience store retailing may be contributing to total revenue growth in the convenience store sector.[4] However, we concluded that Sainsbury's and Tesco's expansion in convenience store retailing was not sufficient to account for total revenue growth in the sector. As we note in paragraph 5.9, revenues are also growing for other convenience store operators, particularly symbol group stores. We discuss Sainsbury's and Tesco's expansion in convenience store retailing further in paragraphs 5.88 to 5.98.

5.11 The moderate growth in convenience store numbers, and the more significant growth in convenience store revenues that we observed, indicates that any distortion in competition between large grocery retailers and other convenience store operators (possible sources of which we discuss in paragraphs 5.88 to 5.89), is not causing a

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[1]IGD data from its annual publication *UK Convenience Retailing*.
[2]IGD states that this level of growth has been driven by consumers' increasing propensity to spend in convenience stores as well as the developments in range and store environment over the last five years. IGD also expects that all categories of convenience stores are likely to continue to improve their offer in order to capture a greater proportion of consumer grocery spend (IGD, *UK Convenience Retailing*, April 2007).
[3]Ibid.
[4]An academic study by Professor Wrigley of the University of Southampton that was commissioned by Tesco, for example, reported that when Tesco converted three One Stop stores in Hampshire to its Tesco Express format they had a 4.3 per cent increase in primary shopping customers and a 14.5 per cent increase in secondary shopping customers. The survey of 650 customers indicated that shopping at local superstores reduced by 6.6 per cent after the opening of the stores (see Professor Neil Wrigley, University of Southampton, *Relocalising Food Shopping*, 2005).

broad-based decline in convenience store numbers or revenues, including the number or revenues of independent non-affiliated and symbol group convenience stores.

Impact of large grocery retailer store entry on convenience stores and specialist grocery stores

5.12 One of the concerns raised during our investigation relates to the impact of new stores operated by large grocery retailers on local convenience stores and specialist grocery stores. For example, residents in locations such as Gerrards Cross in Buckinghamshire and Stalham in Norfolk wrote to us regarding the actual or expected impact of new larger grocery stores on their town centres.

5.13 Given these concerns, we sought to assess the effect of new larger grocery stores and new convenience stores owned by large grocery retailers on independent non-affiliated and symbol group convenience stores and specialist grocery stores in the locality. A decline in the number of independent non-affiliated and symbol group convenience and specialist grocery stores following the opening of a new larger grocery store or a convenience store belonging to a large grocery retailer might indicate a competitive distortion arising from the behaviour of the large grocery retailer (eg below-cost selling). It would not, however, be conclusive evidence of such a distortion because a decline in the number of independent non-affiliated and symbol group convenience stores and specialist grocery stores would also be consistent with undistorted competition (ie consumers shifting their custom to the new larger grocery store as a result of it having a superior retail offer). Full details of this analysis are set out in Appendix 5.2.

5.14 If entry by a new larger grocery store, or convenience store belonging to a large grocery retailer, increases the number of independent non-affiliated and symbol group convenience stores and specialist grocery stores in the locality or leaves it unchanged, it is less likely that the behaviour of large grocery retailers, such as below-cost selling, is distorting competition between large grocery retailers and other grocery retailers.[1]

5.15 To undertake this assessment, we analysed the Experian Goad dataset, which contains details of retail stores in more than 1,000 high streets and retail parks across the UK.[2] We observed a complex picture of both entry and exit for independent non-affiliated and symbol group convenience stores and specialist grocery stores since 2000. We also observed that trends of growth or decline differed from one area to another. Our analysis controlled for these trends in each location and identifies the effect of entry by a larger grocery store, or a convenience store belonging to one of three large grocery retailers (M&S, Sainsbury's or Tesco), into a high street or local shopping area within a one- to two-year period.

5.16 The results showed that over the period 1999 to 2006, entry by a new larger grocery store was, on average, associated with a reduction in the number of greengrocers and trading markets and an increase in the number of bakers in the following one to two years. However, it had no systematic identifiable effect on the number of

[1]While an analysis of the effect of local entry by larger grocery stores may be informative about the presence or effect of certain behaviours that might distort competition, such as below-cost selling, it does not assist us in assessing other potential causes of distortions in competition, such as the waterbed effect.

[2]It is likely that the high street and retail park locations covered in the Experian Goad dataset are narrower than the relevant geographic markets (see paragraphs 4.134 to 4.146). Using this dataset, we are able to identify the impact entry on stores only in the immediate vicinity of the new store. It is likely, however, that the impact of a new store will be greater in these areas so our analysis is likely to capture any significant effect.

butchers, convenience stores, delicatessens, fishmongers, health food stores and off-licences. (Full details of this analysis are set out in Appendix 5.2.)

5.17 Our analysis also shows that, on average, a new M&S, Sainsbury's or Tesco convenience store had no identifiable effect within a one- to two-year period, on specialist grocery stores other than health food shops, for which the number decreased. The analysis also showed that there was a decrease in the number of symbol group convenience stores, but no identifiable impact on the number of independent non-affiliated convenience stores.

5.18 The difference between the effect on the number of symbol group and other grocery retailer convenience stores, on the one hand, and the number of independent non-affiliated convenience stores, on the other hand, following the entry of an M&S, Sainsbury's or Tesco convenience store might be explained by a greater similarity in the retail offer between convenience stores operated by M&S, Sainsbury's, Tesco, other grocery retailers and symbol groups compared with that provided by independent non-affiliated convenience stores. Alternatively, it may be that the small family-owned businesses that often operate independent non-affiliated convenience stores may be more willing to suffer poorer financial returns for a longer period prior to exiting. However, the one- to two-year period covered by our analysis is sufficiently long that some effect would be detected were large-scale exit likely to result from new entry by an M&S, Sainsbury's or Tesco convenience store.

Supplier pricing and the 'waterbed effect'

5.19 The discrepancy between the prices paid to suppliers by large grocery retailers, on the one hand, and by the wholesalers that supply independent non-affiliated and symbol group convenience stores, on the other hand, and the consequent possibility of a 'waterbed effect'[1] has been a key concern of convenience store operators, in particular, in this investigation. In the following paragraphs we review the evidence on supplier prices (also referred to as buying prices or purchasing terms) paid by grocery retailers and wholesalers,[2] and then examine the competitive implications of the differences in supplier prices that we observe, including the possibility of a waterbed effect.

5.20 To assess the variation in supplier prices, we collected detailed pricing, volume and (where possible) cost data at the SKU level for a period of up to five years from 29 suppliers. These suppliers varied in terms of both size and the types of grocery products that they supplied. Our sample covered 141 branded SKUs and represents approximately £1.8 billion of annual sales at wholesale prices, or at least 2 per cent of UK grocery retail sales.

5.21 We undertook two analyses, which are set out in full in Appendix 5.3, using this data: first, a comparison of the average unit and net prices[3] paid by grocery retailers and wholesalers; and second, an econometric analysis of the effect of order size on price.

5.22 Our comparison of average supplier prices showed that:

[1]A waterbed effect occurs when, as a result of large grocery retailers obtaining lower prices from their suppliers, these suppliers increase prices for other grocery retailers and wholesalers.
[2]Our analysis of supplier prices includes the prices paid by various buying groups on behalf of multiple wholesalers. We use the term 'wholesaler' in the remainder of this section to refer to both wholesalers and buying groups.
[3]The unit price is the price 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. The net price is the price net of all discounts, both variable and fixed in nature. Fixed discounts include, for example, point-of-sale support and marketing monies.

- The four largest grocery retailers (Asda, Morrisons, Sainsbury's and Tesco), when analysed together, pay, on average, between 4 and 6 per cent less than the mean.[1] Within this group, Tesco pays, on average, a significantly lower unit price and net price than Asda, Morrisons and Sainsbury's. This average masks variation in the individual prices paid by retailers. Tesco does not always pay less than the other three grocery retailers.

- The average price paid by other large grocery retailers, including CGL, Somerfield and Waitrose, is around the mean, and within this group some pay prices that are similar to those paid by Asda, Morrisons and Sainsbury's.

- Larger wholesalers pay, on average, 2 to 3 per cent above the mean, while smaller wholesalers pay prices that are, on average, 8 to 9 per cent above the mean. There is significant variation in prices paid by individual large wholesalers and smaller wholesalers. Some large wholesalers pay average supplier prices similar to those paid by large grocery retailers (other than the four largest), and in three cases, wholesalers pay supplier prices similar to those paid by Asda, Morrisons and Sainsbury's.[2]

TABLE 5.1 **Average relative prices by grocery retailer/wholesaler group, 2004 to 2007**

Customer type	*Average relative unit price*	*Average relative net price*
Four largest grocery retailers	93.8	95.8
Asda		
Morrisons	[✂]	
Sainsbury's		
Tesco		
Other grocery retailers	100.1	100.4
Large wholesaler/symbol groups	103.4	102.0
Smaller wholesaler/symbol groups	109.0	107.8

Source: CC analysis of supplier information.

Note: Price differential relative to the overall mean price per grocery retailer or wholesaler.

5.23 The differences in average supplier prices that we observe across the spectrum of grocery retailers and wholesalers may be explained by two key factors:

- scale benefits that allow suppliers to offer lower prices on larger orders;[3] and

- greater buyer power for the four largest grocery retailers, particularly Tesco, relative to other grocery retailers and wholesalers.

5.24 Our econometric analysis shows that increased order size is associated with lower prices (net and unit), particularly for non-primary-branded products. However, we cannot use this analysis to assess the extent to which the decline in price as order size increases is attributable to scale benefits or buyer power.

5.25 A range of factors, other than order size, may also contribute to the supplier pricing differentials we observe. For example, these might include the negotiating skill of the

[1]The mean is the average relative price across all customers. For each SKU purchased, we have calculated the annual relative price paid by each customer relative to the average paid by all customers (see Appendix 5.3).
[2]The three wholesalers are [✂], [✂] and [✂]. The results for two of these wholesalers ([✂]) are, however, underpinned by a relatively small number of observations.
[3]Several submissions focused on the economies of scale associated with distribution, and implied that the major difference between customers in terms of the costs incurred by a supplier are whether a customer requires a full or partial truck load. This, however, does not take into account the substantial economies of scale that are likely to be associated with the production, and not just the distribution, of many manufactured food and drink products.

buyers employed by grocery retailers (although larger firms may be more likely to take greater effort to train buyers), the expected growth in sales for the customer, purchasing history with the supplier, and differences in the retail offer between grocery retailers (see Appendix 5.3). In some cases, these factors may be of sufficient importance to allow a relatively small wholesaler to achieve significantly lower average prices from suppliers than the size of its orders alone would imply.

5.26 We did not find that the differences in supplier prices that we observed have an AEC in themselves. (We discuss this further in the context of our analysis of barriers to entry and expansion in paragraphs 7.21 to 7.27.) But, in addition to drawing our attention to these differences in supplier prices, the ACS submitted that the lower prices paid to suppliers by large grocery retailers result in these suppliers charging higher prices to wholesalers (the so-called waterbed effect), and that this has an adverse effect on competition between large grocery retailers and independent non-affiliated and symbol group convenience stores and, ultimately, consumers.

5.27 Under the formal model of the waterbed effect submitted by the ACS[1] ('the ACS model') there is a causal relationship whereby an increase in the size of large grocery retailers increases their buyer power and results in lower prices from suppliers. Large grocery retailers then win customers from convenience stores as a result of reduced retail prices. As convenience stores lose customers, their scale diminishes and their bargaining position with suppliers deteriorates, leading to higher supplier prices and higher retail prices at convenience stores. The remaining customers at convenience stores are worse off as a result of higher prices. Further, all consumers may, on average, be worse off if large grocery retailers do not pass on enough of their lower prices from suppliers in the form of lower retail prices.[2]

5.28 The ACS model demonstrates a logically coherent waterbed effect, but this effect arises only under the specific circumstances set out in the model. As a result, to conclude that a waterbed effect is present in UK grocery retailing, we must believe that the assumptions embedded in the ACS model are a valid representation of UK grocery retailing. The following paragraphs describe the ACS model and discuss in five key areas the extent to which it represents the circumstances that we observed in UK grocery retailing. (A full analysis of the ACS model is provided in Appendix 5.4.)

5.29 First, the model assumes that the extent to which large grocery retailers pass lower prices from suppliers on to consumers through their larger grocery stores is only influenced by the extent of competition from convenience stores. The model assumes no competition between large grocery retailers. However, our analysis of the product market in Section 4 concluded that large retailers operating larger grocery stores compete with one another. Competition between larger grocery stores would ensure that the lower prices large grocery retailers gained from suppliers were passed on to consumers. As a result, if the model were to include competition between larger grocery stores it is likely that consumers, on average, would benefit from lower prices than predicted by the ACS model.

5.30 Second, the ACS model assumes that large grocery retailers gain customers by lowering retail prices, and that all of these customers come from convenience stores. In effect, the model assumes that the market is of a fixed size and that, as a result,

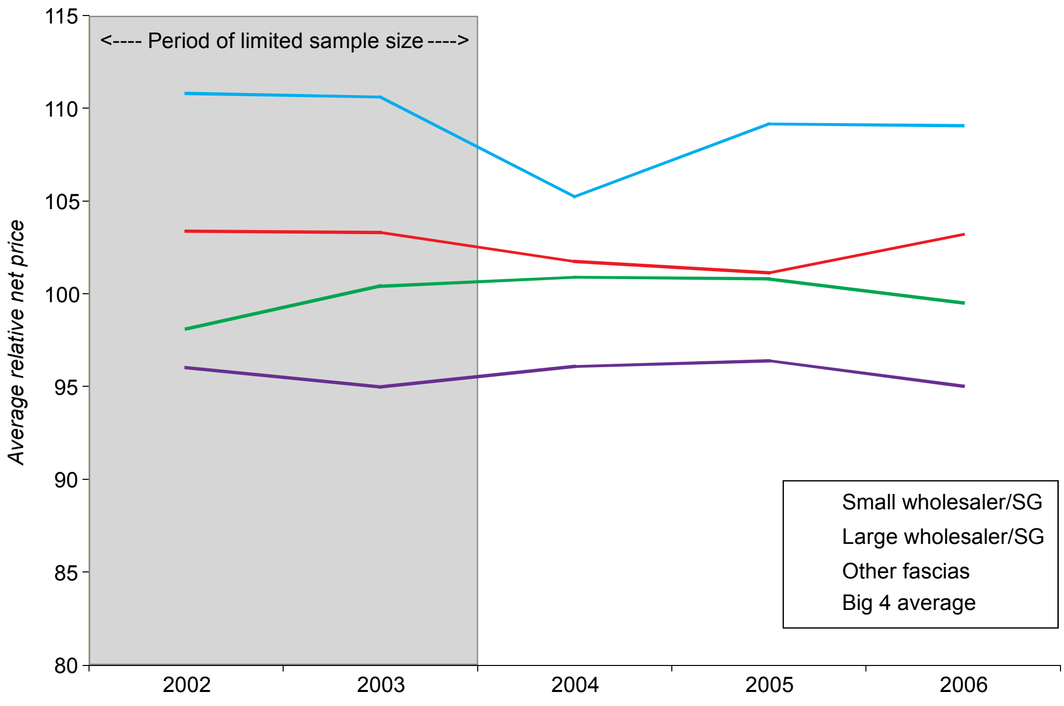
[1] *The 'Waterbed Effect': How Non-Cost Related Discounts to Large Retailers can Harm Consumers*. Published at: www. competition-commission.org.uk/inquiries/ref2006/grocery/pdf/main_party_submissions_acs_waterbed_effect.pdf.
[2] The ACS suggested that, consistent with this model, increasing buyer power held by large grocery retailers may reduce suppliers' profits and result in some suppliers exiting the industry. This will affect the bargaining position of all retailers, as suppliers become more concentrated, but may affect smaller retailers to a greater extent.

one retailer's gain is another retailer's loss. By ignoring the possibility that the total market size might expand in response to lower retail prices (a market expansion effect),[1] the ACS model over-emphasizes the loss of customers by convenience stores, and their consequent loss of bargaining power with suppliers. Further, by omitting a market expansion effect, the model overstates the consumer detriment arising from the waterbed effect by not taking into account the new, additional customers at larger grocery stores that benefit from the lower prices at these stores.

5.31 Third, the ACS model assumes that the size of a grocery retailer influences the extent of its buyer power. As we set out in paragraph 5.37, in practice, a range of factors influence the extent of a grocery retailer's buyer power. Nevertheless, our analysis of supplier pricing showed that there is a statistically significant relationship between price and volume. However, for the waterbed effect to materialize under the ACS model, the difference in prices must consistently widen as large grocery retailers increase in size. Our analysis suggested that where we observe the strongest relationship between price and volume, the relationship may be better characterized as non-linear (see Appendix 5.4).[2] Indeed, the ACS told us that it thought that the relationship between size and price might be non-linear. This is consistent with our observation that despite Tesco's increase in size and national sales share since 2003, its advantage over other grocery retailers in terms of the prices it pays to suppliers has not increased.

FIGURE 5.1

Relative net price by customer type, 2002 to 2006



Source: CC analysis.

[1]It is likely that by lowering retail prices, large grocery retailers may increase total sales and thus increase the total number of consumers benefiting from the lower prices of large grocery retailers.
[2]That is, while supplier prices decline with retailer size, this happens at a decreasing rate, and buying advantages associated with scale may be exhausted beyond a certain threshold.

5.32 Fourth, our econometric analysis indicates that the relationship between price and volume is not uniform across primary and non-primary brands:[1] for primary brands, the relationship is much flatter in the case of net prices, and in the case of unit prices, it is not significant (see Appendix 5.4). That is, for primary brands order size has little, if any, influence on suppliers' prices. This observation indicates a weaker waterbed effect than would be the case if large grocery retailers were consistently able to achieve lower prices from suppliers across the full product range.

5.33 Finally, the ACS model does not allow for the presence of the wholesalers and buying groups that supply convenience stores. The lack of a wholesale sector in the ACS model means that the model, in our view, omits an important dynamic in the competitive interaction between convenience store operators and other grocery retailers. Wholesalers and buying groups, by purchasing on behalf of many convenience store operators, are able to exercise greater bargaining power with suppliers than would be the case by individual convenience store operators.

5.34 The presence of multiple, competing wholesalers that obtain a range of prices from suppliers means that convenience store operators, where disadvantaged by the prices on offer from their wholesaler, will in many cases have the ability to choose an alternative wholesaler that is able to achieve better prices from grocery suppliers. Further, wholesalers that are losing sales to convenience stores as a result of their prices being too high relative to other wholesalers are able to increase their bargaining strength with suppliers by joining a broader buying group. These factors may have influenced the consolidation among grocery wholesalers that has occurred over the past ten years (see paragraphs 5.93 to 5.99 and Appendix 5.5).

5.35 Our analysis of average supplier prices also showed that some large grocery wholesalers are able to obtain prices from suppliers that are on a par with those obtained by a number of large grocery retailers. Although wholesalers charge a mark-up to convenience stores, this indicates that the buying price disadvantage compared with some large grocery retailers may not be that significant.

5.36 We have a number of other concerns, in addition to these five key areas regarding the validity of the assumptions in the ACS model in the context of the UK groceries sector. These are discussed in Appendix 5.4, and include, for example, the assumption regarding the nature of supply contracts in grocery retailing.

5.37 In summary, we concluded that the ACS model, while demonstrating the circumstances under which a waterbed effect could occur, has a number of limitations in terms of its representation of UK grocery retailing. In particular:

- the circumstances that are required under the ACS model for consumers to be worse off do not reflect the competitive dynamics that we observe in UK grocery retailing;

- the ACS model ignores the possibility of market expansion in response to lower retail prices at larger grocery stores;

- the ACS model predicts a widening of the buying price differential between small and large retailers over time, but this does not accord with our own observations of trends in supplier pricing;

[1]In our analysis of supplier pricing, a brand was defined as 'primary' if [✂], March 2007. Other brands were defined as 'non-primary'.

- the weakness of the price–volume relationship in relation to primary branded goods means that any waterbed effect in UK grocery retailing would be significantly weaker than that predicted by the ACS model; and

- the lack of a wholesale function within the ACS model means that an important competitive dynamic is missing from the model that, in practice, allows the buying price disadvantage faced by the convenience store sector to be substantially mitigated.

5.38 The ACS model of the waterbed effect is based on the prices suppliers charge to grocery retailers. However, we also examined whether a waterbed effect might arise in relation to non-price factors. That is, whether wholesalers, for example, might obtain a poorer offer from their suppliers as a result of the service provided to large retailers, and whether this could impact on their ability to compete.

5.39 The GfK supplier survey,[1] conducted for the CC as part of this investigation, provides some evidence for this. Only 7 per cent of suppliers 'agree' or 'strongly agree' that when larger customers negotiate a lower price, prices are increased to smaller customers. However, 40 per cent of suppliers indicated that when demand from large customers increases, smaller grocery retailers might experience shortages. Further, 21 per cent of suppliers indicated that when larger customers require better or additional services, service levels to small customers become worse as a result.

5.40 The fixed nature of the resources available to suppliers, in the short term, means that, compared with prices, there is more likely to be a direct link between increased supply, or improved services, for larger customers and supply shortages, or lower levels of service, for smaller customers. However, while suppliers may favour large customers in response to events, such as supply shortages, they can be expected to readjust their offer once any short-term pressure is relieved so as to provide the desired level of supply, or service, to each customer. For a waterbed effect to operate, the differentials in service would need to persist, and widen, over time. As a result, we concluded that a non-price waterbed effect is unlikely to be present in UK grocery retailing.

5.41 In conclusion, large grocery retailers, particularly the four largest, and especially Tesco, generally obtain lower prices from suppliers than wholesalers. This is likely to reflect a range of factors, including economies of scale and greater bargaining power for large retailers. We did not find these differences in supplier prices in and of themselves gave rise to an AEC for reasons that are discussed in relation to barriers to entry and expansion (see paragraphs 7.29 to 7.31).

5.42 In theory, a buying price differential that led to a waterbed effect, and in turn increased average prices for consumers might give rise to an AEC. The ACS model, by demonstrating how a waterbed effect could take place, represented a significant contribution to our investigation. However, we do not find that the circumstances described or implied by the ACS model of the waterbed effect are met in UK grocery retailing. We examined the possibility of a non-price-based waterbed effect, but did not find that such an effect was likely.

5.43 Finally, if a waterbed effect were present in the UK grocery sector, we would have expected to see unambiguous evidence of an overall decline in convenience store numbers and revenues. As we set out in paragraphs 5.5 to 5.11, we have not found this to be the case.

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

Viability of grocery wholesalers and the convenience store supply chain

5.44 The ACS and the Federation of Wholesale Distributors (FWD) raised concerns regarding the ongoing financial viability of the UK's grocery wholesalers. The problem foreseen by these parties was that a decline in the number of convenience stores increases grocery wholesalers' unit costs as their fixed costs are spread over a smaller customer base. This, in turn, forces wholesalers to increase prices to convenience stores leading to further convenience store closures, and higher average unit costs for the remaining wholesalers. Under this scenario, the grocery wholesale sector reaches a 'tipping point' beyond which it is no longer economically viable, and any remaining convenience stores are left without a functioning supply chain.

5.45 We examined, first, the extent of the financial pressure faced by the grocery wholesale sector as a whole, and second, the likely changes in the grocery wholesale sector that might be observed were it to come under significant financial pressure.

5.46 We reviewed the recent financial performance of the 15 largest grocery wholesalers (which account for approximately three-quarters of sector revenue) to assess whether the industry may be approaching a tipping point in its financial viability. These wholesalers have experienced steady revenue growth in recent years, with average gross margins of 4 to 5 per cent and operating margins of around 1 per cent. Since 2000/01, return on capital employed has been steady for delivered wholesalers, and declining for cash-and-carry wholesalers. The better relative performance of delivered wholesalers compared with cash-and-carry wholesalers reflects the more general shift of independent non-affiliated convenience stores to symbol groups (see paragraph 5.8). Details of this analysis are set out in Appendix 5.5.

5.47 The growth in revenues in the wholesale sector is consistent with our review of convenience store revenues (see paragraph 5.9), which shows convenience store revenues growing faster than grocery sales as a whole. A recent study of the 30 largest grocery wholesalers is also consistent with our analysis, finding that profit margins in the sector increased from 1.5 per cent in 2006 to 1.8 per cent in 2007 and sales increased by 3.2 per cent.[1]

5.48 Industry assessments generally point to growth in grocery wholesaler revenue in the next few years. However, we assessed the extent to which grocery wholesalers would need to lose sales before their viability came into question. The wholesalers with which we discussed this issue suggested that a 20 to 40 per cent reduction in turnover would be necessary to make their businesses unprofitable. Reductions in sales volumes of this order, across the entire wholesaling sector, seem unlikely when compared with industry assessments of growth in wholesale revenues.

5.49 The UK grocery wholesale sector has been characterized by increased consolidation over the past ten years. To the extent that financial pressures were experienced in the sector as a result of convenience store closures, we would expect this to lead to further consolidation among wholesalers to ensure that economies of scale at the remaining wholesalers were maintained, rather than leading to a tipping point in the viability of the entire sector.

5.50 We also examined whether increased grocery wholesaler consolidation might, in some cases, leave certain geographic areas with a limited number of grocery wholesalers competing for the business of convenience stores, and whether, as a result, wholesale prices to convenience stores and convenience store prices to consumers

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[1]IGD, *UK Grocery and Food Service Wholesaling,* March 2007.

might increase. We thought that it would be unlikely that these prices would increase. First, wholesaler consolidation not only generates greater economies of scale and density, it would also strengthen wholesalers' bargaining power with respect to suppliers. As a result, consolidated wholesalers would incur lower costs, some of which would be passed on to convenience stores in the form of lower wholesale prices. Second, given that convenience stores are competitively constrained by mid-sized and larger grocery stores (see paragraph 4.85), we thought it unlikely that even if wholesale prices increased, this would lead to higher convenience store prices to consumers.

5.51 In summary, based on the current and projected financial performance of the grocery wholesaling sector, we conclude that the financial viability of the sector as a whole is not seriously threatened. Further, to the extent that convenience store closures placed grocery wholesalers under financial pressure, we expect that this would first be addressed through industry consolidation rather than leading to a tipping point in the financial viability of the entire sector.

Below-cost selling

5.52 Below-cost selling occurs when a retailer sells an item for less than its input cost.[1] In general, we expect consumers to benefit from the lower prices brought about by below-cost selling, but below-cost selling may raise competition concerns where:

(a) it is a predatory strategy aimed at excluding rivals. If successful, this exclusionary strategy could result in the deterioration of the retail offer to consumers; or

(b) it adversely affects smaller retailers, including convenience store operators and specialist grocery retailers, whether intentional or not, causing them to exit; or

(c) it misleads consumers into thinking that the prices of all products sold by a grocery retailer are lower than is really the case.

Prior to discussing each of these possibilities, we first review the extent and nature of below-cost selling by UK grocery retailers. A full review of below-cost selling is contained in Appendix 5.6.

Below-cost selling by UK grocery retailers

5.53 Ten grocery retailers (Aldi, Asda, CGL, Lidl, Morrisons, Netto, Sainsbury's, Somerfield, Tesco and Waitrose) told us that they engaged in below-cost selling.[2] Below-cost selling represented, by sales value, up to 3 per cent of each retailer's total revenue.

5.54 For most grocery retailers, the majority of below-cost sales relate to two or three product groups. Across all ten grocery retailers, the two main product groups in which items are sold below cost, by sales value, are dry groceries (tinned and packet goods) and alcohol. Other product groups in which items are sold below cost include CDs, DVDs and books, non-alcoholic beverages, confectionery and health and

[1]We have defined a product as being sold below cost if it has a negative gross margin calculated as price less the delivered cost of the product to the grocery retailer including most variable costs, but no contribution to fixed cost.
[2]We asked 15 grocery retailers to provide information on below-cost selling. Ten stated that they engaged in below-cost selling. Of these ten, Netto and Lidl did not provide sales value data for their below-cost selling and CGL had minimal below-cost sales. Four of these 15 respondents told us that they did not engage in below-cost selling, other than in some cases for products reduced to clear, short-dated products and promotions. These were Iceland, M&S, Booths and Costcutter. The remaining respondent, Spar, is a symbol group and told us that it was unable to provide this information on behalf of its members.

beauty products. There is no clear difference between branded and own-label products in the proportion of those products that are sold below cost. The period during which individual products are sold below cost ranges between 8 and 25 weeks. Branded products are generally sold below cost for shorter periods than own-label products.

5.55 Grocery retailers told us that they sold products below cost for the following reasons:

(a) to avoid being beaten on price, either because of a price pledge or a desire to maintain a price differential with other grocery retailers;

(b) to use loss leaders to tempt customers into the store at certain times of the year, such as Christmas, or for events such as the World Cup;

(c) to sell seasonal products such as fresh fruit when there is more stock than necessary to meet customer requirements;

(d) because increases in costs from changes in supplier or supply chain logistics are not immediately reflected in the sales price; and

(e) to support the launch of a new product by selling it below cost.

Predation and below-cost selling

5.56 Predatory pricing involves the short-term sacrifice of profits by temporarily selling items below cost with the intent of raising prices above the competitive level or otherwise profitably deteriorating the retail offer to recoup lost profits once rivals have exited the market. We examined predatory pricing in the context of competition between large grocery retailers and other grocery retailers, particularly independent non-affiliated and symbol group convenience stores and specialist grocery stores.

5.57 Opinion varies as to the conditions necessary for predation to occur.[1] We believe that for below-cost selling by large grocery retailers to be a predatory strategy aimed at operators of independent non-affiliated or symbol group convenience stores or specialist grocery stores, we would need to establish that: *(a)* convenience stores and specialist grocery stores constrain prices at the large grocery retailers' stores; *(b)* large grocery retailers have sufficient market power after the predation to recoup the losses incurred during the predation; and *(c)* barriers to entry or re-entry into convenience store and specialist grocery retailing are high so that new convenience or specialist grocery stores could not open in response to a weakening of the retail offer by large grocery retailers and prevent recoupment of the losses incurred during the predation stage.

5.58 We found that each of these conditions was unlikely to be met other than in exceptional circumstances. First, we found that convenience stores do not, in general, place a competitive constraint on mid-sized or larger grocery stores. As a result, the

[1]Predatory pricing is prohibited by Article 82 of the EC Treaty. In *AKZO v Commission* in 1986, the European Court of Justice held that if a dominant firm sets its price below average variable cost, this conduct is presumed to be a breach of Article 82. Where a dominant firm sets prices that are below average total costs, but above average variable cost, the conduct is a breach of Article 82 if it forms part of 'a plan to eliminate a competitor'. The European Court of Justice's Tetra Pak II judgment in 1996 confirmed that it is not necessary to demonstrate that the dominant firm has the ability to recoup the costs of predation after its rivals exit. In contrast, in US competition law, recoupment is a distinct element of the legal test for predatory pricing. In the 1993 Brooke Group judgment, the US Supreme Court rejected a predatory pricing claim on the basis that there was not sufficient probability of recoupment. In December 2004, the Irish Competition Authority in its Drogheda decision set out a structured 'rule of reason' approach to the investigation of predatory pricing allegations. This approach includes, in particular, an examination of the plausibility of the alleged predation, whether the conduct is rational in an economic sense, and the feasibility of the dominant firm recouping the costs of predation.

predatory elimination of convenience stores by large grocery retailers would not, in general, be able to confer any additional market power on their mid-sized or larger grocery stores. However, as we set out in paragraph 4.137, there may be local markets where stores smaller than 280 sq metres place a competitive constraint on stores larger than 280 sq metres. Further, the predatory elimination of competing convenience stores would remove a competitive constraint on the convenience stores operated by large grocery retailers, such as Sainsbury's and Tesco.

5.59 Second, for a large grocery retailer to recoup losses incurred during any predation period, it would need to eliminate all grocery retailers capable of constraining its prices so that it could subsequently increase prices and recover the profits forgone. This would need to include other large grocery retailers. Alternatively, it would have to collude with the grocery retailers that were not eliminated in the predatory phase to increase prices. The pattern of below-cost selling by large grocery retailers (ie below-cost selling across a limited range of products for a limited period at all stores regardless of location—see paragraphs 5.52 to 5.55) could not, in our view, be characterized as a broad-based predatory strategy aimed at all the effective competitors faced by any individual large grocery retailer. Further, the similar pattern of below-cost selling across large grocery retailers, despite the differing extent to which these retailers face competition from competing convenience store operators (ie only some of the large grocery retailers that we observe engaging in below-cost selling operate convenience stores), suggested that below-cost selling is not targeted at convenience stores but at other large grocery retailers.

5.60 Finally, we did not find significant barriers to entry in convenience store retailing (see paragraph 7.120). As a result, were large grocery retailers to use predatory pricing to eliminate convenience stores the limited barriers to entry into this sector would allow re-entry to occur quickly in response to any subsequent weakening of the retail offer by large grocery retailers.

5.61 In summary, we find that a predatory strategy of using below-cost selling to eliminate convenience stores would not remove the competitive constraint that large grocery retailers face at their larger or mid-sized or their convenience stores from the larger (and mid-sized) grocery stores operated by other large grocery retailers. Further, the limited barriers to entry faced by convenience stores would quickly allow re-entry in response to any deterioration in the retail offer of large grocery retailers. Given these considerations, and the pattern of below-cost selling that we observe, we concluded that the below-cost selling engaged in by grocery retailers could not be characterized as a broad-based predatory strategy aimed at operators of independent non-affiliated or symbol group convenience stores or specialist grocery retailers.

5.62 In a small number of local markets, however, convenience stores may place a competitive constraint on mid-sized grocery stores, and there may be more significant barriers to entry for convenience stores than is the case more generally. In these circumstances, a predatory strategy by a large grocery retailer using vouchers or coupons to attact consumers from a targeted convenience store may be feasible.[1] We discuss local vouchering in paragraphs 5.70 to 5.87.

[1]The lack of localized pricing by most large grocery retailers (see paragraph 6.31) means that vouchers or coupons would be needed as part of local predatory strategy for most large grocery retailers.

Unintended effects of below-cost selling

5.63 Below-cost selling by large grocery retailers might not be a predatory strategy aimed at convenience store operators or specialist grocery retailers, but it might disproportionately affect their stores:

- large grocery retailers, due to their broader product range in mid-sized and larger grocery stores compared with convenience stores, may be better able to cross-subsidize below-cost sales through higher prices on other goods; and
- at least one of the products that grocery retailers typically sell below cost, namely alcohol, is a particularly important source of revenue for convenience stores and off-licences.

5.64 The unintended consequences of below-cost selling on convenience stores, specialist grocery stores and other grocery stores of below-cost selling by large grocery stores would be of concern if it weakened the competitive constraint on the large grocery retailers that engage in below-cost selling. As we set out in paragraph 4.85, however, the competitive constraint placed on mid-sized and large grocery stores by convenience stores and specialist grocery stores is, in most cases, limited and barriers to entry in convenience store retailing and specialist grocery retailing are not significant. Below-cost selling might also be of concern if, in causing the exit of convenience stores and specialist grocery stores, it reduced the choice of grocery retailer available to consumers.

5.65 We examined whether it was possible to identify an effect on convenience stores and specialist grocery retailers from below-cost selling by large grocery retailers. As we note in paragraph 5.54, alcohol is one of the main product categories in which the major grocery retailers engage in below-cost selling.[1] As a result, to the extent that there are unintended consequences for convenience stores or specialist grocery retailers arising from below-cost selling, we might expect to see an effect on off-licences. While not conclusive, our analysis of local market entry by larger grocery stores using Experian Goad data showed that, on average, there is no statistically significant effect on the rate of entry or exit of local off-licences within a one- to two-year period following the entry of a larger grocery store within that locality (see paragraphs 5.15 to 5.18).

5.66 Convenience stores also sell alcohol and might be impacted by below-cost selling of alcohol. However, as for off-licences, our analysis of local market entry by larger grocery stores did not show a statistically significant effect on the number of convenience stores in the locality in the subsequent one- to two-year period (see paragraph 5.17).

Misleading effects of below-cost selling

5.67 Below-cost selling could have an AEC if it resulted in consumers concluding, based on the reduced price of a limited number of products, that the overall cost of shopping at a particular grocery store was lower than in reality. Consumer research, however, shows that the ‘price image’ formed by consumers is based on a great deal of information including non-price factors, and that shoppers do not carry large quan-

[1]Below-cost selling of alcohol by grocery retailers raises a number of important issues in terms of public health and public order that are not related to the effects of this activity on competition in grocery retailing. We discuss our treatment of non-competition issues in Section 2.

tities of product-specific price information with them.[1] The evidence that we reviewed shows that consumers' price comparisons of different grocery retailers are complex and depend not only on the price of a selection of known-value items (KVIs), but also on the basket price and many other factors. Given the prominence of basket prices, we have concluded that consumers are not easily misled by the below-cost selling of a limited number of products, and that this therefore does not prevent, restrict or distort competition between grocery retailers.

Conclusion on below-cost selling

5.68 In conclusion, we find that the pattern of below-cost selling that we observed by large grocery retailers does not represent behaviour that was predatory in relation to other grocery retailers. We also find that this behaviour was not likely to have unintended consequences that would give rise to an AEC. Further, we find that below-cost selling is unlikely to mislead consumers in relation to the overall cost of shopping at a particular grocery store.

5.69 More generally, we note that temporary promotions on some products, including fuel, to attract consumers and increase total sales (commonly referred to as loss leading) may constitute efficient pricing for grocery retailers. Competition between grocery retailers on the total value proposition of the store may represent effective competition between retailers and may benefit consumers by reducing the average price for a basket of products.[2]

Local vouchering

5.70 The practice of distributing vouchers or coupons that offer a discount off the total shopping bill at a particular grocery store (eg £5 off when more than £20 is spent) is a means by which grocery retailers can increase the attractiveness of shopping at an individual store. Most vouchering campaigns provide for a discount off the total cost of shopping. However, a number of retailers also offer vouchers that provide a discount on the price of fuel at their service stations. For grocery retailers with national pricing policies (see paragraph 6.31), local vouchering may be the only way in which it is possible to adjust prices at a local level.

5.71 A number of parties raised concerns regarding local vouchering by grocery retailers, particularly Tesco, in the context of possible predatory pricing strategies. We have already discussed predatory pricing in the context of below-cost selling (see paragraphs 5.52 to 5.69). For us to conclude that local vouchering was being conducted as a predatory strategy, it would need to meet the same conditions that we set out in paragraph 5.52.

5.72 Paragraphs 5.37 to 5.87, first, review the local vouchering practices of large grocery retailers, and second, examine the vouchering campaigns that have been drawn to our attention. In reviewing these specific vouchering campaigns we sought to assess whether there was a broader pattern to the local vouchering activity that we observe that might represent behaviour that has an AEC.[3] Finally, we reviewed the use of petrol pricing discount vouchers by grocery retailers.

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[1]*Price image research review*, February 2004 to January 2005, conducted by the University of Warwick and commissioned by [✂]. (See extract published in working paper on pricing practices at: www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/emerging_thinking_pricing_practices.pdf.)
[2]Generally, it is optimal for grocery retailers to spread their fixed costs over as many sales as possible; the higher the sales of a grocery retailer, the lower the average cost, which, absent coordination, results in lower average prices for a basket of groceries. They can achieve this if they set higher margins on those products for which consumers are less price sensitive and lower margins on those products for which consumers are more price sensitive.
[3]Predatory conduct can also infringe Chapter II of the Competition Act 1998 and Article 82 of the EU Treaty.

Local vouchering practices of grocery retailers

5.73 Asda, M&S, Morrisons, Sainsbury's, Tesco's and Waitrose all told us that they engaged in local vouchering. In general, grocery retailers use vouchering to support a new store opening or the extension or refurbishment of an existing store. Large grocery retailers may also use local vouchering in response to entry or store refurbishment by other large retailers or in response to other large retailers' vouchering campaigns.[1]

5.74 Tesco spends significantly more on local vouchering than any other UK grocery retailer. Over the period March 2003 to June 2006, Tesco's expenditure on local vouchering was £[✂] million. Tesco told us that its expenditure on local vouchering was higher than usual in 2004 and 2005 due to [✂]. In comparison, Asda told us that its expenditure on local vouchering was £[✂] million in 2004 and £[✂] million in 2006.

5.75 The ACS argued that vouchering could be predatory and provided us with various examples of vouchering campaigns that it considered raised competition concerns (see paragraphs 5.76 to 5.81). None of the large grocery retailers that use vouchering told us that this strategy was used specifically to target convenience stores.

Review of individual vouchering campaigns

5.76 In Withernsea, Yorkshire, between January and February 2004, Tesco ran a voucher promotion for four weeks offering £8 off for every £20 spent at its 900 sq metre Tesco Metro store. This campaign had been preceded by a similar four-week campaign in July 2003 following the opening of the Tesco store. Each campaign represented between 13 and 20 per cent of average monthly revenue at the Tesco store.[2] According to the ACS, the campaign was targeted at a successful independent grocery retailer, Proudfoot. We are not aware of any other grocery stores in Withernsea of similar or larger size than the Tesco Metro store. An investigation of Tesco's local vouchering in Withernsea was conducted by the OFT in 2004 who found that these campaigns did not breach the Chapter II prohibition in the Competition Act 1998, which prohibits the abuse of a dominant position in a market.

5.77 We were told of five other specific examples of vouchering by Tesco that were characterized as the aggressive targeting of a competing retailer:

- *Ludlow, Shropshire*. Tesco redeemed vouchers to the value of £[✂] at this store in May 2006 as part of a local vouchering campaign. This campaign represented approximately [✂] per cent of average monthly revenue at this store. Concerns were raised regarding the impact of this vouchering campaign on a grocery store operated by Harry Tuffins.

- *Cleethorpes, Lincolnshire*. Tesco redeemed vouchers to the value of £[✂] at this store in November 2004, October 2005 and March 2006 as part of local vouchering campaigns. Each campaign represented less than [✂] per cent of average monthly revenue at this store. Concerns were raised regarding the impact of these vouchering campaigns on local Nisa-Today's convenience stores.

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[1]Vouchering is only one possible response to entry by a large competitor. We discuss grocery retailers' responses to competitor entry in paragraphs 6.36 to 6.46.
[2]Due to data limitations, the first campaign is calculated as a proportion of revenue in that month.

- *Grimsby, South Humberside*. Tesco redeemed vouchers to the value of £[✂] at its Tesco Extra store in Grimsby during vouchering campaigns in August 2005, following the opening of its store, and in March 2006. The first campaign resulted in voucher redemptions that represented around [✂] per cent of the store's revenues in that month, while the subsequent campaign resulted in redeemed vouchers that represented less than [✂] per cent of the store's average monthly revenue that year. Concerns were raised regarding the impact of these vouchering campaigns on local Nisa-Today's convenience stores.

- *Bellshill (Coatbridge), North Lanarkshire*. Tesco replaced its store in Coatbrige with a new Tesco Extra store in November 2005. Tesco redeemed vouchers at both the original store and the replacement store during vouchering campaigns in 2005. It redeemed vouchers with a total value of £[✂] at the original Tesco store in Coatbridge in February and May 2005 (both campaigns representing less than [✂] per cent of average monthly revenue at that store) and £[✂] at its new Tesco Extra store in Coatbridge in November 2005 following the opening of that store, which represented less than [✂] per cent of the store's revenues in that initial month.

- *Hull, Yorkshire*. Tesco redeemed vouchers to the value of £[✂] in three campaigns in September 2003, October 2004 and April 2005. The October 2004 vouchering campaign coincided with the extension of the nearby Asda Kingswood. Each campaign represented less than [✂] per cent of average monthly revenue at this store. Concerns were raised regarding the impact of these vouchering campaigns on local Nisa-Today's convenience stores.

5.78 Tesco's local vouchering campaigns typically last four weeks and its average expenditure per campaign was approximately £[✂], although there was significant variation around the average, as was illustrated by the examples reviewed.

5.79 In each of these cases mentioned, there was at least one mid-sized or larger grocery store belonging to a large grocery retailer within a 10- to 15-minute drive-time of the Tesco store at which vouchers were redeemed: *(a)* in each of Cleethorpes, Grimsby and Hull, there was an Asda store within a 10- to 15-minute drive-time of the Tesco store at which vouchers were redeemed; *(b)* in Coatbridge, there were six competing larger grocery stores within a 10-minute drive-time of the Tesco store including one Asda store and three Morrisons stores; and *(c)* in Ludlow, there was a Somerfield store that was approximately 75 to 80 per cent of the size of the Tesco store at which vouchers were redeemed.

5.80 There would be little point in Tesco forcing the exit of the individual stores identified in paragraph 5.77 through predatory behaviour as the presence of the competing stores that we identify would place a major constraint on any subsequent weakening of the retail offer as a means of recovering any losses incurred during these vouchering campaigns.

5.81 We analysed the Experian Goad database to assess whether Tesco's campaigns had an impact on entry and exit of convenience stores and specialist grocery stores. We recognized that this database does not include all stores that might have been affected by these vouchering campaigns, but considered that its coverage was sufficient to provide an indication of exit and entry in these areas. Our analysis indicated that entry and exit of convenience stores and specialist grocery stores in these locations followed longer-term trends and did not change at the time of Tesco's vouchering campaigns.[1]

Petrol pricing discount vouchers

5.82 Concerns were also raised regarding the use of vouchers that link grocery purchases to the price of fuel. Evidence from Sainsbury's and Tesco suggests that fuel vouchering campaigns were usually national, rather than local. Tesco told us that its fuel vouchering campaigns lasted from four to six weeks, while Sainsbury's told us that its campaigns lasted for two to five weeks with an additional two-week period for customers to redeem their vouchers.

5.83 Whether or not fuel vouchering campaigns represent below-cost selling, we did not find that the national fuel vouchering campaigns by grocery retailers were predatory based on the conditions set out in paragraph 5.57. Moreover, competitors to large grocery retailers in fuel distribution include large multinational firms such as Shell and BP, making it unlikely that a grocery retailer could either drive these competitors out of business through predatory conduct, or increase prices following any predatory phase.

5.84 The ACS has suggested that fuel discount vouchers distort competition by encouraging consumers to shop at the stores of the grocery retailer offering the fuel discount, rather than at other grocery stores. It is possible that fuel vouchering diverts trade from other stores and puts these stores, at least temporarily, under competitive pressure. However, given the limited timescale of these campaigns, it is unlikely that such strategies cause the exit of stores unable to offer fuel discounts such that there is any meaningful lessening of the competitive constraint on those large grocery retailers that offer fuel discounts.

5.85 We looked for other relevant examples of fuel vouchering by grocery retailers. The ACCC carried out an investigation in 2004, which concluded that fuel vouchering was unlikely to adversely affect competition in petrol and grocery wholesaling and retailing. On the contrary, the ACCC concluded that this practice brought lower fuel prices to consumers and increased non-price competition from independent retailers who engaged in innovative responses to fuel vouchering aimed at inducing loyalty. The ACCC also noted that changes affecting the grocery markets, such as growth of the main grocery retailers and the consolidation of the independent sector, were not a consequence of fuel vouchering schemes.[2]

Conclusion on local vouchering

5.86 In conclusion, we find that the local vouchering activities of most grocery retailers are not extensive. Competition concerns have only been raised with us in the context of the vouchering activities of one grocery retailer, Tesco. Having reviewed the local vouchering campaigns by Tesco that have been brought to our attention, we do not find that these formed part of a pattern of activity that might be considered predatory or otherwise have an AEC. Similarly, we do not find that the fuel discount vouchering activities of large grocery retailers have an AEC.

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[1]In Cleethorpes, the number of convenience and specialist grocery stores remained stable over 1999 to 2006. In Grimsby, some specialist grocery stores, such as bakers, increased in numbers during this period. Similarly, in Hull the number of health food stores increased, while the number of off-licences decreased. Ludlow and Coatbridge experienced some variations in both directions in the number of specialist grocery stores within different store categories.
[2]*Assessing shopper docket petrol discounts and acquisitions in the petrol and grocery sectors*, Australian Competition and Consumer Commission, February 2004, pp 46–47.

5.87 We recognize that grocery retailers may lose business in areas where Tesco or other large grocery retailers are conducting vouchering campaigns. However, we conclude that vouchering campaigns, in the absence of predatory behaviour, represent effecttive competition between retailers that benefits consumers by reducing their shopping bills.

Expansion by Sainsbury's and Tesco in convenience store retailing

5.88 One of the major developments in convenience store retailing since 2000 is Sainsbury's and Tesco's expansion in this sector, primarily through the acquisition of a number of convenience store operators that operated multiple convenience stores. As set out in Table 3.4, Sainsbury's acquired 179 convenience stores in 2004 and 2005 by purchasing the Beaumonts, Bells, Jacksons and Shaws convenience store chains, while Tesco acquired 915 convenience stores in 2003 and 2004 through its acquisition of T&S Stores and Adminstore. CGL also made substantial acquisitions in the convenience store sector during this period, acquiring 778 convenience stores between 2002 and 2004 by purchasing the Alldays, Balfour and Conveco convenience store businesses. CGL's merger with United Co-operatives Limited in 2007 added approximately 620 convenience stores to its portfolio.

5.89 Sainsbury's and Tesco own approximately 4 per cent of convenience stores in the UK and earn approximately 13.3 per cent of total convenience store revenues.[1] This represents only a small proportion of the revenues in the all-grocery-stores product market.

5.90 The concerns raised with us regarding the expansion by Sainsbury's and Tesco in convenience store retailing related to their established and substantial presence in mid-sized and larger grocery stores. Sainsbury's and Tesco's expansion in the convenience store sector is likely to have been supported in large part by their existing advantages in terms of brand reputations, low purchasing prices and distribution networks.

5.91 Entry by operators of mid-sized and larger grocery stores into the convenience store sector is not of itself anti-competitive. If entry by these retailers brings low prices and an improved retail offer to the convenience store sector, consumers will benefit. The IGD states that as the number of convenience stores operated by large grocery retailers continues to grow, standards are expected to increase across the sector. It also states that the presence of Tesco and Sainsbury's in this sector ensures a high level of price competition, which is likely to increase as they expand their portfolios of convenience stores.[2]

5.92 We would be concerned about Tesco's and Sainsbury's expansion in the convenience sector if this resulted in a weakening in the competitive constraint on Tesco or Sainsbury's 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.

5.93 The ACS argued that Tesco and Sainsbury's entry into the convenience store segment had not always resulted in an improved retail offer. In particular, the ACS said that One Stop stores continued to have an inferior retail offer, including higher prices than Tesco Express stores, and that these differences could not be accounted for by differences in costs. The ACS also suggested that pricing policies implemented

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[1]IGD, *UK convenience retailing*, April 2007.
[2]Ibid.

by Sainsbury's through Jacksons and Bells might not reflect Sainsbury's pricing more generally. We have not, however, seen evidence of a deterioration in the retail offer for consumers following the acquisition of these stores by Tesco and Sainsbury's.

5.94 It is possible that predatory conduct associated with Tesco's and Sainsbury's expansion in the convenience store sector could lead to a deterioration in their retail offer in the future. However, we considered possible predatory behaviour in the context of both below-cost selling and local vouchering in paragraphs 5.52 to 5.69 and 5.70 to 5.87, and concluded that the behaviour of large grocery retailers is not consistent with predatory conduct.

5.95 It was put to us that Tesco's expansion in the convenience store sector results in a lack of choice for consumers (often referred to as the 'Tesco town' phenomenon). We discuss local market concentration and its effects in detail in Section 6. In relation to any possible interaction between local market concentration for larger grocery stores, and consumer choice in convenience stores, we sought to identify areas where Tesco and Sainsbury's have both a strong local market position for larger grocery stores and a concentration of convenience stores, and examined whether this was impacting on consumers' choice of convenience store.

5.96 Using our grocery store database, we identified 136 Tesco larger grocery stores that were monopoly or duopoly stores based on a 15-minute drive-time. In only 12 of these areas did Tesco operate three or more convenience stores within a 10-minute drive-time. (The number of areas with three or more Tesco convenience stores increases to 35 when a 15-minute drive-time is considered.) For each of these areas, we considered the number of rival stores (both in terms of number of stores and number of fascias) within both 10- and 15-minute drive-times.

5.97 The smallest number of competing stores was in Leighton Buzzard, Bedfordshire, where we identified three rival stores belonging to three different grocery retailers within 10 minutes' drive-time and an additional rival store within a 15-minute drive-time. In all other areas, we identified a larger number of competing stores. In practice, the number of rival stores is likely to be even higher in these areas given that our grocery store database did not include independent non-affiliated convenience stores as well as large numbers of independently-owned symbol group stores. We therefore conclude that, at present, Tesco's entry into the convenience store sector has not significantly limited consumer choice.

5.98 We carried out a similar analysis for Sainsbury's. We found that, of the 60 areas where Sainsbury's larger grocery stores are in a monopoly or duopoly position, there was only one area where Sainsbury's owned more than three convenience stores within a 10-minute drive-time of its larger grocery store. The number of areas increased to four when we increased the drive-time to 15 minutes. The smallest number of competing stores was in Guisborough, North Yorkshire, where Sainsbury's owned four convenience stores while there was only one rival store (a large Morrisons store) within a 10-minute drive-time, and two further competing stores within a 15-minute drive-time. Similarly, we conclude that at this stage, Sainsbury's entry into the convenience store sector has not significantly limited consumer choice.

Findings on distortions in competition between grocery retailers

5.99 In summary, we examined whether competition between grocery retailers, particularly between large grocery retailers and independent non-affiliated and symbol group convenience store operators, might be distorted, and looked at the likely presence or impact of:

- a waterbed effect in supplier pricing to grocery retailers;
- a 'tipping point' in the financial viability of grocery wholesalers;
- below-cost selling;
- local vouchering; and
- expansion by Tesco and Sainsbury's in convenience store retailing.

5.100 We found that large grocery retailers, particularly the four largest grocery retailers and especially Tesco, generally obtain lower prices from suppliers than wholesalers. We conclude that these differences in supplier prices in and of themselves do not give rise to an AEC—see paragraphs 7.29 to 7.31). Further, we did not find evidence that lower supplier prices for the four largest grocery retailers resulted in higher supplier prices for other grocery retailers and wholesalers. (That is, we did not find a waterbed effect to be operating in UK grocery retailing.)

5.101 We conclude that the current and projected financial performance of the grocery wholesaling sector did not support a finding that the financial viability of the sector as a whole is threatened. Further, to the extent that convenience store closures placed grocery wholesalers under financial pressure, we expect that this would first be addressed through industry consolidation rather than leading to a 'tipping point' in the financial viability of entire sector.

5.102 We do not find that the pattern of below-cost selling by large grocery retailers represented behaviour that was predatory in relation to other grocery retailers, and do not find that it was likely to have unintended consequences that would represent an AEC. Further, we do not find that below-cost selling is likely to mislead consumers in relation to the overall cost of shopping at a particular grocery store. We find that temporary promotions on some products, including fuel, to attract consumers and increase total sales (commonly referred to as 'loss leading') may represent effective competition between retailers and may benefit consumers by reducing the average price for a basket of products.

5.103 The local vouchering activities of most grocery retailers are not extensive. Competition concerns have only been raised with us in the context of the vouchering activities of one grocery retailer, Tesco. Having reviewed the local vouchering campaigns that have been brought to our attention, we do not find that these form a pattern of activity that might be considered predatory or otherwise have an AEC. Similarly, we do not find that the fuel price discount vouchering of large grocery retailers has an AEC. In our view, vouchering campaigns, in the absence of predatory behaviour, represent effective competition between retailers that benefits consumers by reducing their shopping bills.

5.104 Sainsbury's and Tesco's expansion in convenience store retailing is likely to have been supported in large part by their existing advantages in terms of brand reputations, low purchasing prices and distribution networks. We did not find that this expansion resulted in a weakening of 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.

5.105 These findings are supported by our review of convenience store numbers and revenues, which shows moderate growth in convenience store numbers and more significant growth in convenience store revenues in recent years as well as our analysis of the impact of new larger grocery stores, and convenience stores belonging to large grocery retailers, on the presence of convenience stores and specialist grocery stores.

6. Concentration in local markets for grocery retailing

6.1 This section assesses the extent of concentration in local markets for grocery retailing in the UK (see paragraphs 6.3 to 6.28), and then examines the link between highly-concentrated local markets and the retail offer for consumers (see paragraphs 6.29 to 6.73).

6.2 Where barriers to entry are present, the extent of local market concentration indicates the intensity of competition between grocery retailers by measuring, for example, the number of competitors in a local market or market shares. Given the presence of barriers to entry (which we examine in Section 7), a grocery retailer with few competitors or a high market share will face a weaker competitive constraint from other grocery retailers. For the reasons set out in paragraphs 6.74 to 6.76, we conclude that consumers are likely to experience a poorer retail offer than would otherwise be the case in stores that face a weaker competitive constraint.

Extent of local market concentration in grocery retailing

6.3 The following paragraphs, first, set out the methodology we used to estimate the extent of local market concentration in grocery retailing, second, report the results for the larger grocery stores product market and the mid-sized and larger grocery stores product market, and finally, discuss the extent of local market concentration in the all-grocery-stores product market.

Methodology for estimating the extent of local market concentration

6.4 Our approach to estimating the extent of local market concentration in grocery retailing is set out in paragraphs 6.5 to 6.13. We discuss, in particular, two key aspects:

- our approach to defining local markets so as to measure concentration (given the large number of grocery stores in the UK); and
- the choice of market concentration measure.

Defining local markets to estimate concentration levels

6.5 We set out in Section 4 our definition of the markets for grocery retailing. The following paragraphs apply these market definitions so as to estimate the extent of local market concentration in UK grocery retailing. There are, in principle, two ways in which this task could be undertaken.

6.6 First, we could begin at the level of each grocery store in the UK and define the scope of the individual local geographic market by analysing the cluster of stores around each store that could, hypothetically, be monopolized profitably (see paragraphs 7.99 to 7.101 for a description of this process). We could then measure the level of concentration in each of these local markets, and aggregate the results to arrive at a national-level estimate of concentration. However, given that there are more than 4,000 mid-sized and larger grocery stores in the UK, such an exercise would be extremely time consuming and labour intensive. It would require a large amount of very detailed information from parties and was not feasible in the context of this investigation.

6.7 Second, we could use the approach foreshadowed in paragraph 4.89, and employ a uniform drive-time around each grocery store to give an approximation of the scope of that store's local market and then measure concentration within each of those approximated markets. Using a uniform drive-time to define the geographic scope of local markets will result in some stores being included in, or excluded from, certain local markets solely on the basis of the methodology used. Nevertheless, the use of a uniform drive-time addresses the practical problems of the first approach and allows a useful approximation of the overall extent of local market concentration. In adopting this second approach, we estimated local market concentration using uniform drive-times at both 10 and 15 minutes' drive-time around each store.[1]

Measuring market concentration

6.8 There are a number of ways to measure market concentration. These include measuring the number of competitors in a market, the relative size of competitors as measured by sales shares (either by revenue or volume) 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.[2] For the purposes of assessing the extent of concentration in local markets for grocery retailing, we used two distinct measures: first, retailers' shares of groceries sales area as a proxy for share of sales, and second, the number of competing fascias.

6.9 The market share of a grocery retailer provides an indication of the extent of the competitive constraint that its store faces. A retailer that has a small market share will not enjoy any meaningful degree of market power, whereas a retailer that has a large market share is more likely to benefit from market power. We conducted an initial assessment of local market concentration using two different market share thresholds, 40 per cent and 60 per cent. However, a retailer with a market share of more than 60 per cent is much more likely to possess market power than a retailer with a 40 per cent market share. For this reason, we decided to focus our analysis on grocery stores operated by retailers that have a local market share greater than 60 per cent.[3]

6.10 The number of competing fascias in a local market provides another indication of the extent of the competitive constraint faced by particular stores within that market. The greater the number of fascias, the greater the number of alternatives to which customers can switch following any weakening of the retail offer at a store. Where a grocery store faces zero, one or two competitor fascias (ie monopoly, duopoly or triopoly stores), and the retailer operating that store has a high market share that retailer is likely to face little to no competitive constraint in that market.[4] Our margin

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[1]In Section 7, however, where we reviewed individual controlled landsites as a barrier to entry (see paragraphs 7.98 to 7.107), we defined each relevant local market precisely rather than using a uniform drive-time. We concluded that such an approach was appropriate when analysing features which may have an AEC and accordingly may require a remedy, but that it was not required for the purposes of assessing the overall extent of highly-concentrated local markets in the UK.
[2]Formally, the Herfindahl-Hirschman Index is defined as the sum of squares of all of the market shares in the market.
[3]The evidence that we reviewed suggests that the extent of competition increases with the share of net sales area of nearby competitors. Our margin concentration analysis shows, for example, that increasing a competitor's market share from 40 to 60 per cent would reduce the incumbent store's margin by 3.1 per cent.
[4]We would expect tripoly stores to face a greater competitive constraint than duopoly stores, but where the market share threshold is as high as 60 per cent, there are, in practice, few tripoly stores.

concentration analysis showed that each additional competing fascia in a local market has a lesser impact on the profit margin of the incumbent store.[1]

6.11 The combination of these two criteria (ie the number of competitors and market share) allowed us to take both of these criteria into account in assessing the extent of local market concentration. In our view:

- a retailer that operates a grocery store that faces a small number of competitor fascias and has a high local market share will enjoy local market power;
- a retailer that operates a grocery store with only one or two competitor fascias (ie a duopoly or triopoly store) but has a small local market share (ie share of groceries sales area) is unlikely to enjoy a meaningful degree of market power; and
- a retailer with a large local market share and a significant number of competitor fascias will have sufficient alternatives for its customers that it is unlikely to enjoy a meaningful degree of market power.

6.12 As a result, where we had sufficient data to estimate both measures of concentration, we based our overall estimate of local market concentration on a combination of fascia count and share of groceries sales area such that it captured stores that both face few competitor fascias and whose retailers have a high share of groceries sales area.[2]

6.13 In summary, to assess the extent of local market concentration, we 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.[3] We defined these markets as 'highly-concentrated local markets'.[4]

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[1]The impact on the incumbent store's profit margin declines non-linearly with the number of competing fascias. The effect of an additional competitor on a store's profit margin is much larger for monopoly stores than for stores that already have two competitors within a 10-minute drive-time. An additional fascia will reduce the store-level profit margin by at least 4.3 per cent for a monopoly store, whereas for an incumbent store that already faces one competing fascia an extra competitor will reduce its profit margin by 3.6 per cent, while for an incumbent store that already faces two competing fascias an extra competitor will reduce its profit margin by 2.95 per cent, and for an incumbent store that already faces three competing fascias an extra competitor will reduce its profit margin by 2.29 per cent. The effect of additional fascias declines as the number of competing fascias increases (see Appendix 4.4).

[2]These measures of concentration should, however, be interpreted with care. When products are differentiated, concentration measures alone may not fully reflect the degree of competition. This is a particular concern in retail markets because, by virtue of their location relative to one another and relative to populations, some own-fascia or competitor stores within the relevant geographic market will provide a stronger competitive constraint on the incumbent than others. In our detailed site-by-site assessment of the grocery retailers' controlled land in Section 7, we have taken account of these factors. However, given the large number of grocery stores in the UK, such an exercise is not practical in the context of this analysis.

[3]A detailed analysis of an individual local market may, however, reveal that it is highly concentrated even though one fascia has a share of groceries floorspace that is less than 60 per cent, eg this may be the case when a grocery store faces very few competitors, such as when the local market is a duopoly.

[4]Our analysis is undertaken using a database of stores provided by the main parties in response to the main party questionnaire as at June 2006. Some stores included in the analysis may have since closed or been relocated, and other stores may have since opened and will not be reflected in the analysis. The overall effect on the total number of highly-concentrated local markets will depend on where these stores are located and the structure of the local market. Although our estimates of the number of highly-concentrated local markets are based on June 2006 data, we have no reason to think that the current situation is significantly different from the situation as of June 2006.

Local market concentration in the larger grocery stores product market

6.14 Using the approach set out in paragraph 6.7, our analysis shows that, using a 10-minute drive-time, 495 larger grocery stores[1] in the UK (27 per cent of all larger grocery stores) are in highly-concentrated local markets.[2] Where a 15-minute drive-time is used, 209 larger grocery stores (11 per cent of all larger grocery stores) are in highly-concentrated local markets (see Appendix 6.1).

6.15 Using a 10-minute drive-time to define local markets, each of Morrisons and Tesco has around 30 per cent of all of their larger grocery stores in highly-concentrated markets (see Table 6.1). A smaller proportion of Asda's and Sainsbury's larger grocery stores are in highly-concentrated local markets (23 and 26 per cent respectively).

6.16 Of the total number of larger grocery stores in highly-concentrated local markets, Tesco accounts for the largest proportion (around 31 per cent), while Morrisons and Sainsbury's each account for about 20 per cent and Asda accounts for a smaller proportion (14 per cent).

TABLE 6.1 **Larger grocery stores in highly-concentrated local markets within a 10-minute drive-time, by retailer**

	Number of stores in highly-concentrated local markets	*Stores in highly-concentrated local markets as a proportion of retailers' larger grocery stores* %	*Stores in highly-concentrated local markets as a proportion of all stores in highly-concentrated local markets* %
Asda	68	23	14
CGL	15	43	3
Regional Co-ops	10	24	2
M&S	6	15	1
Morrisons	103	29	21
Sainsbury's	98	26	20
Somerfield	11	15	2
Tesco	151	31	31
Waitrose	27	27	5
Other	6	40	1
Total	495	27	100

Source: CC.

Note: ''Other' includes larger grocery stores operated by Booths, Budgens, Nisa-Today's, Proudfoot and Spar.

6.17 Using a 15-minute drive-time to define local markets, each of CGL, Morrisons, Tesco and Waitrose has a similar proportion of its larger stores in highly-concentrated local markets (around 14 per cent)—see Table 6.2. A smaller proportion of Asda's and Sainsbury's larger grocery stores are in highly-concentrated local markets (around 10 per cent).

6.18 Of the total number of larger grocery stores in highly-concentrated local markets, Tesco accounts for the greatest proportion (around 30 per cent), while Morrisons and

[1]For the purposes of this analysis we considered larger grocery stores with a groceries sales area larger than 1,400 sq metres ('target stores'), while effective competitors to these target stores were larger grocery stores with a groceries sales area larger than 1,400 sq metres or larger than 75 per cent of the target store's groceries sales area. (In practice, this means that for a larger grocery store of 1,400 sq metres in groceries sales area, effective competitors would include all other larger grocery stores with a groceries sales area of more than 1,050 sq metres.)
[2]In counting the number of stores in highly-concentrated local markets the figures in paragraph 6.14 and elsewhere in this section refer to the number of 'centre stores' in highly-concentrated local markets, rather than the total number of stores in these markets (eg in a 'triopoly' local market only the centre store is counted and not the other two stores).

Sainsbury's account for about 20 per cent, and Asda accounts for a smaller proportion (around 13 per cent).

TABLE 6.2 **Larger grocery stores in highly-concentrated local markets within a 15-minute drive-time, by retailer**

	Number of stores in highly-concentrated local markets	*Stores in highly-concentrated local markets as a proportion of retailers' larger grocery stores*	*Stores in highly-concentrated local markets as a proportion of all stores in highly-concentrated local markets*
		%	*%*
Asda	28	9	13
CGL	5	14	2
Regional Co-ops	2	5	1
M&S	0	0	0
Morrisons	49	14	23
Sainsbury's	41	11	20
Somerfield	4	5	2
Tesco	63	13	30
Waitrose	13	13	6
Other	4	27	2
Total	209	11	100

Source: CC.

Note: 'Other' includes larger grocery stores operated by Booths, Budgens, Nisa-Today's, Proudfoot and Spar.

6.19 In a small number of cases, these stores may be in areas where small populations limit the number of larger grocery stores that can be supported. However, in other cases, barriers to entry may be constraining new entry.[1] In either case, consumers are adversely affected by the fact that the market is highly concentrated rather than more competitive. In practice, it is difficult to estimate the extent to which small populations may be limiting the number of stores in an area. We observed a positive relationship between the size of the population and the number of larger grocery stores in an area, but we also found many areas where a relatively small population supported a number of larger grocery stores. We also observed many areas where, despite there being a relatively large population in the area, there were few larger grocery stores.[2] As a result, any adjustment based on the size of population required to support a certain number of larger grocery stores results in very few markets being excluded.[3] (We discuss population-based adjustments in the context of our analysis of the persistence of highly-concentrated local markets in Appendix 7.3.)

Local market concentration in the mid-sized and larger grocery stores product market

6.20 Using a 10-minute drive-time, our analysis shows that 1,005 mid-sized and larger grocery stores[4] in the UK (22 per cent of all mid-sized and larger grocery stores) are

[1]Tesco told us that highly-concentrated local markets existed for reasons other than barriers to entry. As well as small populations, Tesco said that these included: a lack of demand from customers for certain grocery retailers' offerings; the presence of mid-sized grocery stores (and LADs stores) in absorbing grocery demand; and other grocery retailers' decisions to abstain from growth or to maintain only a restricted set of formats. We do not believe that these reasons, however, adequately explain highly-concentrated local markets and discuss this further in Appendix 6.1.
[2]For example, Galashiels in Selkirkshire, Scotland, has a population of 31,000 within a 20-minute drive-time. In 2006, it had two larger grocery stores: a Somerfield store of [✂] sq metres and a Tesco store of [✂] sq metres. However, since then, Tesco replaced its larger grocery store with a [✂] sq metre store and Asda opened an [✂] sq metre larger grocery store showing that large grocery retailers consider that a population of 31,000 is able to support three larger grocery stores (see Annex 1 of Appendix 7.1 for further examples of large grocery stores in areas with relatively small populations).
[3]Using a similar methodology to that set out in Annex 1 of Appendix 7.1, we find that between 5 and 10 per cent of larger grocery stores in highly-concentrated local markets, using a 10-minute drive-time, are in areas where a small population might limit further entry.
[4]This total includes the 495 larger grocery stores referred to in paragraph 6.14.

in highly-concentrated local markets using a 10-minute drive-time.[1] Where a 15-minute drive-time is used, there are 472 mid-sized and larger grocery stores (10 per cent of all mid-sized and larger grocery stores) in highly-concentrated local markets (see Appendix 6.1).

6.21 These figures may include some mid-sized grocery stores that, in practice, are not in highly-concentrated markets owing to a number of mid-sized grocery stores belonging to symbol groups and some regional grocery retailers not being included in our store database. On the other hand, some of the mid-sized grocery stores that are not in our database may also be in highly-concentrated local markets. As a result, we decided that this was a reasonable basis on which to estimate the total number of mid-sized and larger grocery stores in highly-concentrated local markets.

6.22 Using a 10-minute drive-time, Morrisons, Tesco and CGL each have a similar proportion of stores competing in the mid-sized and larger stores product market in highly-concentrated local markets (around 30 per cent). A smaller proportion of Asda's and Sainsbury's stores competing in the mid-sized and larger grocery stores product market are in highly-concentrated local markets (about 24 per cent).

6.23 Of the total number of mid-sized and larger grocery stores in highly-concentrated local markets, Tesco accounts for the greatest proportion (around 21 per cent), while Somerfield accounts for about 14 per cent. CGL, Morrisons, regional Co-ops and Sainsbury's each account for about 11 per cent of the mid-sized and larger grocery stores in highly-concentrated local markets, while Asda accounts for a smaller proportion at around 7 per cent.

TABLE 6.3 **Mid-sized and larger grocery stores in highly-concentrated local markets using a 10-minute drive-time, by retailer**

	10-minute		
Fascia	*Number of stores in highly-concentrated local markets*	*Stores in highly-concentrated local markets as a proportion of all retailers' mid-sized and larger grocery stores* %	*Stores in highly-concentrated local markets as a proportion of all stores in highly-concentrated local markets* %
Asda	69	23	7
CGL	125	32	12
Regional Co-op	108	26	11
M&S	12	3	1
Morrisons	115	31	11
Sainsbury's	122	25	12
Somerfield	141	17	14
Tesco	212	29	21
Waitrose	38	21	4
Other	63	13	6
Total	1,005	22	100

Source: CC analysis.

Note: 'Other' includes mid-sized and larger grocery stores operated by Booths, Budgens, Costcutter, Nisa-Todays, Proudfoot and Spar.

6.24 Using a 15-minute drive-time, CGL, Morrisons and Tesco each have a similar proportion of their mid-sized and larger stores in highly-concentrated local markets

[1]For the purposes of this analysis, we considered mid-sized and larger grocery stores with a groceries sales area larger than 280 sq metres ('target stores'), while effective competitors to these target stores were larger grocery stores with a groceries sales area larger than 1,000 sq metres within a 10-minute (or 15-minute) drive-time of the target store, and mid-sized stores with a groceries sales area of between 280 and 1,000 sq metres within a 10-minute drive-time of the target store. Effective competitors must also have a groceries sales area larger than 1,400 sq metres or greater than 75 per cent of the target store's groceries sales area and be larger than 280 sq metres.

(around 15 to 20 per cent). A smaller proportion of Asda's, Sainsbury's, Somerfield and Waitrose's mid-sized and larger grocery stores are in highly-concentrated local markets (around 10 per cent).

6.25 Of the total number of mid-sized and larger grocery stores in highly-concentrated local markets, Tesco accounts for the greatest proportion (around 22 per cent), while CGL and Somerfield each account for about 14 per cent. Morrisons and Sainsbury's account for around 11 per cent of the mid-sized and larger grocery stores in highly-concentrated local markets and Asda accounts for about 6 per cent.

TABLE 6.4 **Mid-sized and larger grocery stores in highly-concentrated local markets using a 15-minute drive-time, by retailer**

		15-minute	
Fascia	*Number of stores in highly-concentrated local markets*	*Stores in highly-concentrated local markets as a proportion of all retailers' mid-sized and larger grocery stores*	*Stores in highly-concentrated local markets as a proportion of all stores in highly-concentrated local markets*
		%	*%*
Asda	28	9	6
CGL	67	17	14
Regional Co-op	46	11	10
M&S	0	0	0
Morrisons	57	15	12
Sainsbury's	51	10	11
Somerfield	71	9	15
Tesco	103	14	22
Waitrose	15	8	3
Other	34	7	7
Total	472	10	100

Source: CC analysis.

Note: 'Other' includes mid-sized and larger grocery stores operated by Booths, Budgens, Costcutter, Nisa-Todays, Proudfoot and Spar.

6.26 There may be a few cases, as with larger grocery stores, where small populations limit the number of mid-sized and larger grocery stores that can be supported. In other cases, barriers to entry may be constraining new entry. In either case, consumers may be adversely affected by the fact that the market is highly concentrated rather than more competitive.

Local market concentration in the all-grocery-stores product market

6.27 Given the much larger number of stores in the all grocery stores product market (around 56,000 stores compared with approximately 4,600 stores in the mid-sized and larger grocery stores product market and approximately 1,800 stores in the larger grocery stores product market), we have not been able to analyse systematically the extent of local concentration across the UK in this product market. We expect, however, that, given the number of stores in this market, the proportion that are in highly-concentrated local markets is substantially smaller than in the larger grocery stores product market and the mid-sized and larger grocery stores product market.

6.28 The limited barriers to entry to this product market (see paragraph 7.122) indicate that the degree of concentration in local markets, in any event, is less of a concern (see paragraph 6.2).

Relationship between local market concentration and the retail offer

6.29 We examined the extent to which those grocery retailers that are present in several local markets adjust their retail offer on the basis of local competitive conditions, and, in particular, to the level of local market concentration.[1]

6.30 We would, in principle, expect there to be a link between the retail offer that is observed at the local level and the intensity of local competition. Grocery retailers have an incentive to weaken their retail offer in those markets where competition is less intense to earn greater profits. However, in practical terms, varying the retail offer locally involves administrative and other costs that need to be balanced against the additional profits that might be earned through such a strategy.[2]

6.31 Our examination of the way in which grocery retailers formulate their retail offer indicated that grocery retailers set many significant components of their retail offer uniformly, or near uniformly, across their stores. Pricing, which is probably the single most important aspect of the retail offer, is currently set uniformly across larger stores by most of the eight grocery retailers active in the larger grocery stores product market (see paragraph 4.85). However, this is a relatively recent development. Prior to 2000, a number of these grocery retailers engaged in a degree of localized price-setting (or price-flexing). Two retailers—CGL and Somerfield—continue to employ localized pricing practices that allow the level of prices at each store to respond to the degree of local competition.[3] We questioned a number of the large grocery retailers regarding their ability to adopt localized pricing. Our assessment is that it remains open to other large grocery retailers to return to similar localized pricing structures.[4]

6.32 In addition to pricing, substantial other parts of the retail offer for grocery retailers are also set nationally on a uniform, or near uniform, basis. Asda, Sainsbury's and Tesco all have centrally managed product promotions that run in all their stores (with some variation according to whether stores stock the product in question). Product range for many retailers is also, in large part, uniform across stores with variations for the most part being a function of store size, and in some cases, other factors such as the region in which the store is located, and the affluence and ethnicity of the population in the store's catchment area. Similar to pricing, and subject to the trade-off set out in paragraph 6.30, our assessment is that there is no reason why grocery retailers could not vary these components of the retail offer according to the degree of local competition.

6.33 The fact that many grocery retailers set a substantial proportion of their retail offer nationally on a uniform, or near uniform, basis across all their stores does not, how-

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[1]In paragraph 6.2, we describe the link between concentration and competition. Given this link, in the remainder of this section we refer to highly-concentrated local markets and weak competition in local markets interchangeably.
[2]There are other strategic reasons why grocery retailers may choose to set a uniform retail offer. For example, it might send a signal to rivals that a grocery retailer will accommodate local entry, saving on the cost of aggressive competition. It also greatly improves price transparency and in the context of tacit coordination, it is much easier to monitor rivals' prices so that price cuts are likely to be detected quickly. We discuss tacit coordination in grocery retailing in Section 8.
[3]We set out details of the local pricing practices of CGL and Somerfield in Appendix 6.2.
[4]We noted that, elsewhere in Europe, one of these retailers—Tesco—has employed a more localized pricing policy. In December 2005, the European Commission stated that in relation to Tesco's operations in the Czech Republic and Slovakia 'Tesco's pricing policy includes a significant local aspect. For a basket of the most popular grocery items the prices of the important local competitors of each Tesco store are checked on a daily basis and subsequently lowered in the relevant store in case any of the local competitors has a lower price for any of these items' (Decision of the European Commission, *Case No COMP/M.3905—Tesco/Carrefour (Czech Republic and Slovakia)*, 22 December 2005. Tesco told us that it set uniform prices in all its stores in the UK because: *(a)* its customers would spot local price differences, lose trust in Tesco and switch away from it in large numbers; *(b)* its rivals would exploit any price differences; *(c)* there are operational efficiencies from the doing the same thing everywhere wherever possible; *(d)* it has built a national brand image (including publicizing its prices on a national website); *(e)* it believed that different locations across the UK were more similar in their characteristics than they were different; and *(f)* almost all of its larger competitors also price nationally.

ever, mean that the degree of concentration in local markets for grocery retailing is not important. The degree of local market concentration could influence the retail offer in two ways:

- through influencing those components of the retail offer that are adjusted locally at the store level (see paragraphs 6.34 to 6.63); and

- through influencing the overall level at which nationally uniform components of the retail offer are set (see paragraphs 6.64 to 6.73).

Local market concentration and locally-adjusted components of the retail offer

6.34 There are, as we set out in paragraph 4.16, many differentiating factors in the retail offer between grocery stores. Differentiating factors that might be adjusted at the store level—even within the overall framework that most grocery retailers currently employ for setting their retail offer (set out in paragraphs 6.29 to 6.33)—include stock availability, the level of service, the number and type of food counters, the number and type of store amenities (such as toilets, ATMs and cafes), speed of checkout service, cleanliness and opening hours.

6.35 We reviewed evidence from three sources to assess the extent to which grocery retailers adjust components of their retail offer at the store-level in response to local competitive conditions, namely:

- qualitative evidence from grocery retailers regarding the way in which they respond to local competition;

- assessments of how individual components of the retail offer vary with the extent of local competition; and

- an analysis of the extent to which store-level profit margins vary with the extent of local competition.

We discuss each of these in turn below.

Evidence from grocery retailers on their response to local competitive conditions

6.36 Grocery retailers provided us with a significant amount of evidence regarding the way in which they vary aspects of their retail offer, including pricing, food counters, store presentation and staffing according to local competitive conditions, and, in particular, in response to changes in local competitive conditions brought about through the opening of new stores by competing retailers.

6.37 Both CGL and Somerfield operate multiple price bands where the band to which a store is allocated takes into account local competitive conditions, while Asda, M&S, Morrisons, Sainsbury's, Tesco and Waitrose each told us that it used local vouchering, which allowed the average prices to be reduced at the store level (see paragraphs 5.73 to 5.81). For most of these retailers, vouchers are principally used at the time of new store openings or extensions or in response to a new opening, extension or store refurbishment by a competitor in the local area.

6.38 As we set out in paragraph 5.74, Tesco undertakes substantially more local vouchering than do other grocery retailers, spending nearly £[✄] million on local vouchering between June 2003 and June 2006. Tesco, however, stressed what it considered to be the *de minimis*[1] nature of its local vouchering.[2] In contrast, M&S told us that its use of vouchering was very limited, but that it might respond to local entry by offering a special promotion on, for example, wine.

6.39 We found that store refurbishments were a common response to entry by a competing retailer.[3] A number of retailers, including Asda, M&S, Morrisons and Waitrose, told us that the opening of a new store by a competitor would often cause them to reprioritize the refurbishment of their own store in the area. CGL told us that entry by a competitor would cause it to review a number of aspects of the offer at a local store, including initiatives such as increased stocking of fresh produce, and noted that this would contribute to additional store costs due to the operation of additional fridges and increased product wastage.[4]

6.40 We found that food counter initiatives are also used as a response to local competitive conditions. Sainsbury's told us that competition from a Waitrose store might be the 'tipping point' in the decision to add a fish counter to a store. M&S told us that in response to the recent entry by Whole Foods Market, it had upgraded the bakery counter and redesigned the patisserie counter in its Kensington store.

6.41 We found that improved staffing is also a response adopted by retailers when faced with increased local competition. M&S told us that the opening of a new competitor store might result in it appointing a more experienced store manager to the store in question. The new store manager would generally have a higher salary than the previous incumbent. M&S also told us that it might respond to new entry by increasing staffing levels and the seniority of staff more generally. Sainsbury's told us that to compete locally, it 'lines up … resource where competition is toughest'.

6.42 Sainsbury's told us that it had developed some trials to improve the retail offer in stores that competed directly with Waitrose. These trials were intended to address customer feedback that Sainsbury's retail offer did not match Waitrose's with regard to range, store environment and staff capability. In addition, Waitrose told us that wherever possible within its national strategy it would take account of the features and characteristics of local markets—for example, local competing fascias, services such as the availability of bag packers, opening hours, and local/regional ranges and refurbishment cycle.

6.43 M&S told us that it responded to new competitor openings through price- (and other) related activities, such as range, store layout, and possible store refurbishments, at the competing M&S store. M&S also looked at varying different aspects of the retail offer in a local store according to the identity of the competitor. For example, if the competitor focused on the standards of its fresh produce, M&S would respond in kind, whilst with other competitors M&S was likely to undertake a pricing-focused review.

6.44 Tesco told us that it undertook a limited amount of short-term local marketing in response to investments by local competitors, such as the refurbishment of a rival store. Tesco said that it undertook this type of marketing when it identified competitor

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[1]We note that Tesco's average annual expenditure on local vouchering over the period 2003 to 2006 was, for example, considerably greater than Sainsbury's annual expenditure on national television advertising (£[✂] million).
[2]Tesco told us that much of the local activity between June 2003 and June 2006 was associated with [✂].
[3]Other factors retailers take into account when deciding whether or not to refurbish a store include maintaining asset value, whether a refurbished store might have more sales potential in the local area, and whether physical constraints (such as lack of car parking) can be rectified.
[4]CGL told us that in a store refit, it would almost invariably put in more fresh food and that this would increase store running costs.

activity that it anticipated would have a negative effect on sales at its existing store of more than [✂] per cent or £[✂] sales per week.

6.45 In addition, Tesco distributes its *Price News* leaflet promoting low-price products and messages in areas around those of its stores that it has designated as 'price sensitive'. In some cases the leaflets are distributed to postcodes that lie between those stores and other retailers with strong price offers (typically Asda, Sainsbury's and Morrisons).[1]

6.46 Other localized competitive initiatives we were told about included the allocation of scarce products to stores in more competitive areas[2] and increases in the number of home delivery vans in an area. Further details of the way in which grocery retailers vary their retail offer at the store level are provided in Appendix 6.2.

Individual components of the retail offer and local competitive conditions

6.47 We reviewed two studies that seek to assess the extent to which individual aspects of the store-level retail offer vary across local markets in response to competitive conditions. The first study was submitted by Tesco, while the second study (the GfK study) was carried out on our behalf by GfK, a market research firm.

6.48 Tesco submitted an analysis of various components of the retail offer including price, range, stock availability and checkout waiting times at its stores larger than 1,400 sq metres. This analysis did not find a statistically significant relationship between increased local concentration and an inferior retail offer. We examined Tesco's analysis in considerable detail and our views on its methodology and results are set out in Appendix 6.3. We had several methodological concerns regarding the analysis, including a number of counter-intuitive results, which showed that certain aspects of a store's retail offer actually improved if that store faced fewer competitors.[3]

6.49 The GfK study assessed the extent to which 18 individual aspects of the retail offer[4] at stores larger than 1,400 sq metres varied across 44 locations in the UK with different degrees of retailer concentration.[5] Most of these aspects of the retail offer were store specific, although pricing, which we would expect to be largely uniform across areas regardless of concentration given the current pricing policies of most grocery retailers, was also included in the study.

6.50 In those aspects of the retail offer that were measured in the GfK study, relatively little variation was detected across local areas. Product range was marginally better in those stores where there was more than one competing retailer, but as the study was able to include only a limited number of products it is difficult to draw strong conclusions regarding this effect. As with the Tesco study, however, we cannot be confident that the measures that were included in this study are capable of fully

[1]Tesco also occasionally runs additional promotions in stores to meet the offers of specific competitors, [✂]. These promotions typically involve an average of [✂] product lines, and in the first 26 weeks of the 2006 financial year, Tesco expenditure on these competitor-facing promotions was around £[✂] million.
[2]For example, [✂] had recently allocated supplies of [✂] and [✂] preferentially to those stores facing greater local competition.
[3]We consider that the absence of any logical explanation for such a result illustrates the shortcomings of this analysis. Tesco told us that its regression analysis did not adequately control for factors such as the physical characteristics of the store, local customer demographics and customer preferences, and that some stores, for which these missing variables are important, are responsible for the counter-intuitive results. We discuss the Tesco analysis further in Appendix 6.3.
[4]Individual aspects of the retail offer included in the study were price (across a small but representative basket of products), quality (via an assessment of damaged or out-of-date products), range (through the number of brands within certain product categories), product availability (within certain product categories), and a service rating of staff, facilities and cleanliness.
[5]The GfK report can be found on the CC's website at:
www.competition-commission.org.uk/inquiries/ref2006/grocery/pdf/gfk_local_case_studies.pdf.

reflecting all the different aspects of the store-specific retail offer. As a result, we place limited weight on the findings of this study.

6.51 More importantly, we had concerns regarding the premise of both of these studies. Many aspects of the store-specific retail offer are intangible and have no identifiable metric with which to measure variation from store to store.[1] We concluded that the studies were therefore not capable of fully reflecting or measuring all of the elements of the retail offer. This is to be contrasted with our margin-concentration analysis (see paragraphs 6.52 to 6.63 and Appendix 4.4). The margin-concentration analysis does not involve direct observation of variations in particular aspects of the retail offer at individual stores; however, a store's profit margin incorporates all such variations, and as such, it does not raise the measurement issues inherent in the Tesco and GfK studies. Given this, and the methodological concerns discussed above, we placed limited weight on the findings of both the Tesco analysis and the GfK study.

Store-level profit margins and local competitive conditions

6.52 As noted in paragraph 6.51, an alternative to measuring individual aspects of the store-specific retail offer is to assess the impact of local competition by examining store-level profit margins. Grocery retailers have an incentive to weaken their retail offer in those markets where competition is less intense in order to earn greater profits. As a result, we might expect to observe higher profit margins at those stores facing weak competition. We set out in paragraphs 6.36 to 6.46 the different initiatives of grocery retailers in relation to stores that face greater competition. In practical terms, a grocery store in a highly competitive area might earn lower profits as a result of:

(a) local vouchering that reduces average store-level prices (although there may be an offsetting effect from higher expenditure by both existing and new customers);

(b) store refurbishments that impose both one-off and ongoing costs (eg increased electricity consumption to operate more chiller cabinets for fresh food, increased product wastage from greater fresh food availability);

(c) greater leafleting and local marketing and the associated costs; and

(d) increased staff numbers to ensure higher levels of service and increased average staff costs as higher-quality staff are employed.

6.53 Given this, we undertook a systematic analysis of the extent to which store-level profit margins for larger grocery stores vary with the intensity of local competition. This analysis, which is set out in detail in Appendix 4.4, shows that more intense local competition results in lower store-level variable profit margins.

6.54 The magnitude of the variation that we observe in store-level profit margins in the larger grocery stores product market caused by differences in the extent of local competition is small, but economically and statistically significant. We found that the presence of an additional competitor store within a 10-minute drive-time reduced the store-level profit margin of a monopoly store by approximately 3.8 per cent.[2] We estimate that, for an average larger grocery store, this would translate into a profit

[1]For example, it is extremely difficult to measure quality and service adequately.
[2]The extent of this effect is most likely greater than 3.8 per cent. This is because our analysis does not allow the impact of entry to affect store profit margins differently according to the number of competitors that they face. We expect that the impact of an extra competitor on the profit margin of a monopoly store will be greater than the impact on a duopoly store. That impact will in turn be greater than the impact on a triopoly store. As a result, the impact on a monopoly store will be greater than 3.8 per cent.

reduction of £300,000 to £350,000 a year.[1] Based on a mid-point estimate of approximately 350 larger grocery stores in highly-concentrated local markets,[2] 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—see Table 6.3.)

6.55 Morrisons and Tesco told us that it was not possible to conclude that weak local competition had an impact on store-level profit margins. Tesco told us that the higher store-level variable profit margins we observe in our analysis was the result of erroneously including fixed-cost elements in our calculation of the store-level profit margin. Tesco considered that a substantial portion of staff costs were fixed rather than variable, and as a result, our analysis only captured a 'volume effect'. That is, the higher store-level profit margins that we observed in local markets with few competitors reflect the larger volume of sales at these stores rather than a weaker retail offer. However, in our view, while staff costs may have a fixed element in the very short term, our analysis uses annual margin data and staff costs are variable over this period. In addition, because our analysis is based on variations in store-level profit margins across stores, even if a portion of staff costs were fixed, this would not affect our results (see our technical explanation in Appendix 4.4). Morrisons and Tesco also raised a number of technical issues with our econometric analysis. We discuss these in Appendix 4.4. We concluded that the issues raised by Morrisons and Tesco do not undermine the robustness of our results.

6.56 The impact of local market concentration on store level profits would be substantially greater were grocery retailers to vary more of their retail offer, such as prices, in response to local competitive conditions. As we note in paragraph 6.31, uniform national pricing by grocery retailers has been adopted only relatively recently and there is no reason, in principle, why those retailers employing national pricing could not revert to a more localized pricing policy. In any event, uniform national pricing does not mitigate the effect of local market concentration; weak competition in local markets will impact on nationally-set pricing levels as well as on other components of the retail offer that are set on a uniform national basis. We discuss this further in paragraphs 6.64 to 6.73.

6.57 In the mid-sized and larger grocery stores product market, there are a number of operators that adjust more of their retail offer at a store level than at a national level.

[1]We provide an indication of the impact of the 3.8 per cent reduction in profit margin on cost and revenues using information on the average store in our sample. The average profit margin of Asda, Morrisons, Sainsbury's and Tesco stores above 1,400 sq metres is [✂] per cent. From the estimates of our margin-concentration analysis, the presence of an additional fascia of more than 1,400 sq metres in the relevant isochrone will reduce store profit margin of stores above 1,400 sq metres by 3.8 per cent. This implies a new store profit margin of [✂] per cent. Using average revenue and cost figures, we can infer the impact of this profit reduction. The average revenue is £[✂] a month and the average variable costs are £[✂] a month. If costs are kept constant while only revenue changes, this 3.8 per cent reduction in profit margin corresponds to a decrease of £29,504.50 in monthly revenues. Alternatively, if revenues are constant while only costs change, the reduction in the store profit margin corresponds to a monthly increase of £25,261.50. Multiplying this by 12 gives an estimated annual loss in variable profit from an additional competitor fascia of between £303,138 and £354,054.

[2]If a 15-minute drive-time is used, the total number of larger grocery stores facing weak competition is 209 (see paragraph 6.14) and the additional store-level profits arising from weak competition is £65–£75 million or 2 per cent of the combined 2007 profits of the four largest grocery retailers. If a 10-minute drive-time is used, the total number of larger grocery stores facing weak competition is 495 (see paragraph 6.14) and the additional store-level profits arising from weak competition is £150–£170 million or 4 per cent of the combined 2007 profits of the four largest grocery retailers. We have used the mid-point between 209 stores and 495 stores for the purposes of deriving a single point estimate.

As we set out in paragraph 6.31, CGL[1] and Somerfield,[2] which have a much greater presence in mid-sized grocery stores compared with larger grocery stores (see paragraph 3.9), operate pricing policies that allow the level of prices at each store to respond, to a degree, to the level of local competition. Further, symbol group retailers are more flexible in terms of allowing owners of stores affiliated to these groups to adjust their retail offer individually. As a result, we expect that stores in this product market that face few local competitors might engage in more store-specific adjustments to the retail offer compared with the product market for larger grocery stores.

6.58 Data limitations, however, mean that we are unable to estimate the extent to which store-level variable profit margins in the mid-sized and larger grocery stores product market vary in response to the degree of local competition. Nevertheless, there are 444 to 1,005 mid-sized and larger grocery stores in highly-concentrated local markets (the figure varies depending on whether a 10-minute or 15-minute drive-time is used to define the boundary of the local market—see paragraphs 6.14 to 6.19). Allowing for larger grocery stores already included in our assessment in paragraphs 6.20 to 6.25, there are a further 235 to 510 mid-sized grocery stores earning additional profits due to weak local competition (ie a range similar to that for larger grocery stores). We believe that the additional store level profits at these mid-sized stores as a result of weak local competition are of a similar order to that at larger grocery stores given the number of stores involved and the greater representation of grocery retailers that vary more of their store-level retail offer, including prices, in response to local competitive conditions.

6.59 We also considered highly-concentrated local markets in the all grocery store product market. As we set out in paragraph 6.27, the number of local markets in the all-grocery-stores product market that are highly concentrated is likely to be quite small. The effect of this concentration on the retail offer is likely to be limited due to the limited barriers to entry in the convenience store sector (see paragraph 7.7). Any excess profits from high concentration would be likely to attract entry within a relatively short period of time, and address the effects of high concentration on the retail offer.

Conclusion on local market concentration and locally-adjusted components of the retail offer

6.60 Grocery retailers provided us with a substantial amount of evidence regarding the way in which local competitive conditions affect their store-level retail offer, at both larger and mid-sized grocery stores.

6.61 To assess the impact of local competition on the store-level retail offer we studied variations both in individual components of the store-level retail offer and in store-level profit margins. We concluded that little weight could be placed on studies that seek to assess the impact of local competition on the store-level retail offer by observing variations in its individual components or a collection of those components. This is due to the great difficulty in measuring certain aspects of the store-level retail offer (eg quality of service) and the further difficulty of capturing all the different

[1]CGL told us that it operated a national pricing policy that was primarily influenced by store format, but it was intermittently responsive, to a degree, to the level of local competition. More specifically, it uses a system of price bands, where the price band to which a store is allocated depends on store format (convenience or not) and local competitive conditions.
[2]Somerfield told us that its price flexing system allows it to respond predominantly to different levels of cost. More specifically, it defines price tiers for its stores according to the cost to serve customers, local demographics and competitor intensity and it has a system of determining or varying the format of a store according to these conditions. Its system will default to the 'standard' format for any store facing highly competitive conditions, while stores in less competitive areas or areas in which it is expensive to operate might become 'premium' or 'convenience' formats.

elements of the store-level retail offer in these studies. In our view, store-level profit margins, by capturing all the influences on a store's revenues and costs, more comprehensively reflect the store-level retail offer.

6.62 Our analysis of the extent to which store-level profit margins for larger grocery stores vary with the intensity of local competition shows that more intense local competition results in lower store-level profit margins. For example, we found that an additional competitor store within a 10-minute drive-time of a larger grocery store would reduce the store-level profit margin of the incumbent store by approximately 3.8 per cent. For an average larger grocery store, this would translate into a profit reduction of £300,000 to £350,000 a year.

6.63 We estimate that the cumulative effect of weak local competition on store-level profit margins allows grocery retailers to earn an additional £105–£125 million in profits per year at their larger grocery stores. This represents around 3 per cent of annual profits for the four largest grocery retailers. The additional store-level profits at mid-sized grocery stores as a result of weak local competition may be of a similar order.

Local market concentration and nationally-set components of the retail offer

6.64 We also examined the extent to which local market concentration will influence those components of the retail offer that are set on a uniform, or near uniform, basis at the national level.

6.65 We concluded that a grocery retailer that has many stores in highly-concentrated local markets would be expected to set prices (or other aspects of its nationally uniform retail offer) at a higher level than would be the case were these stores facing stronger local competition for the reasons set out below.

6.66 The total effect of any price change by a grocery retailer is determined by the effect of the change at each individual store operated by that retailer. This, in turn, depends on the local competitive conditions faced by each store. Where competitive conditions facing individual stores are weak, fewer customers will be lost by the retailer following a price increase. A grocery retailer that has a collection of stores facing weak local competition will, as a result, face less of a constraint from its competitors than a grocery retailer that has stores facing stronger local competition.

6.67 In theory, two grocery retailers might each have 50 per cent of national sales. In one case, this might reflect an equal market share in each local market. In this case, each grocery retailer will be influenced by the actions of its competitor. However, in another case, a 50 per cent share of national sales might reflect a monopoly position for each of the two grocery retailers in half of the local markets across the country. In these circumstances, each grocery retailer would not face any constraint from the other (except in the border region where their stores face each other).

6.68 The observed pattern of concentration in UK grocery retailing does not reflect either of these examples. However, these examples assist in explaining the proposition that the additional profits earned by grocery retailers as a result of weak local competition will depend on two key factors: first, the degree of local competition faced by each store belonging to a retailer; and second, the proportion of a retailer's stores that face little or no competition. In paragraphs 6.14 and 6.19 we set out that the proportion of larger grocery stores for the four largest grocery retailers that face limited competition ranges from 10 to 30 per cent depending on the retailer and the drive-time that was used (ie 10 or 15 minutes). For mid-sized and larger grocery stores, this proportion again ranges from 10 to 30 per cent for the four largest grocery retailers (see paragraphs 6.20 and 6.26). We believe that that this proportion is large enough for each of the four largest grocery retailers to have a significant effect on their national prices.

6.69 Consistent with this, Asda told us that the extent to which it faced its competitors in different local markets across the UK had a clear impact on its national strategy, including pricing. It told us that:

> To the extent there is a lack of local competition, we believe that is reflected in two ways. One, where PQRS are set locally, that is likely to be reflected locally. Secondly, to the extent PQRS are set nationally, we think that the aggregation of the local competition conditions will be reflected in the way those strategic parameters, if you like, were set nationally. So we think local competition feeds through in both of those ways.

6.70 This does not necessarily mean that each grocery retailer draws an explicit link in its internal analysis between the number of its stores facing weak local competition and the level at which it sets prices. However, we concluded that the impact of local market concentration is embedded in the overall effect on the retailers' total revenues and profits arising from national pricing decisions and therefore these local competitive conditions would, in aggregate, influence national pricing decisions.

6.71 In paragraph 6.54 we set out our estimate of the additional profits earned by grocery retailers at larger grocery stores that are attributable to increased store-level profit margins due to weak local competition (ie £105–£125 million a year). (We similarly discuss the additional profits earned by grocery retailers at mid-sized grocery stores that are attributable to weak local competition in paragraph 6.62.) Given the data that would be required, it was not, however, feasible to estimate the additional profits earned by grocery retailers that are attributable to variations in prices or other aspects of the retail offer that apply uniformly, or nearly uniformly, across stores, in response to weak local competition.[1]

6.72 Nevertheless, had competition in more local markets been more intense, the decline in UK grocery prices that has been observed until recently (see paragraphs 3.40 to 3.41) may well have been greater. The scale of the impact on national price levels arising from weak local competition, while difficult to measure, is potentially very substantial. For example, for each 0.1 per cent increase in national price levels, consumer expenditure on groceries at the four largest grocery retailers increases by £80 million a year.[2]

6.73 In summary, as most large grocery retailers do not currently vary prices at the store level, any weakness in local competition will be reflected in higher national prices rather than higher prices at stores where competition is weak. We found that between 11 and 27 per cent of larger grocery stores, and between 10 and 22 per cent of mid-sized and larger grocery stores are in highly-concentrated local markets. (In a number of these highly-concentrated local markets, a grocery retailer with a strong local market position has more than one store in that local market. Our analysis of multiple stores in highly-concentrated local markets is set out in Appendix 7.1. We consider whether remedies are needed to address multiple stores in highly-concentrated local markets in paragraphs 11.256 to 11.268.) If the propor-

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[1]In principle, it would be possible to estimate the increased profits that a grocery retailer earns through higher national prices by assessing the extent to which changes in national prices levels for a retailer vary with changes in the proportion of its stores that face weaker local competition. In the context of this investigation, where it has not been possible to collect information that allows an assessment of changes in local market concentration over time, such an analysis has not been feasible.
[2]This assumes that there is no change in volume of groceries purchased. We think that this is a reasonable assumption for a small change in prices.

tion of stores in highly-concentrated local markets were to increase further, we would expect higher national prices and larger profit margins for the large grocery retailers. Alternatively, if retailers were to start varying prices and other aspects of the retail offer that are currently applied uniformly, or near uniformly, across stores, we would expect that prices and store-level profit margins would increase at those stores that face weak competition and decrease at those stores that face strong competition.

Conclusion on local market concentration in grocery retailing

6.74 We find that between 11 and 27 per cent of larger grocery stores, and between 10 and 22 per cent of mid-sized and larger grocery stores are in highly-concentrated local markets. In contrast, relatively few convenience stores face weak competition. Some mid-sized and larger grocery stores may be in areas where small populations limit the number of mid-sized and larger grocery stores that can be supported. However, in other cases, barriers to entry may be constraining new entry.

6.75 We conclude that consumers are adversely affected by local markets being highly concentrated rather than more competitive. Weak competition in local markets allows a grocery retailer to worsen the store-specific retail offer at its stores in those markets and earn higher profit margins at those stores. In addition, a grocery retailer with a number of stores in local markets where competition is weak is able to weaken that part of its retail offer, such as pricing, that it applies uniformly, or near uniformly, across its stores nationally and thereby earn higher profits across all of its stores.

6.76 We estimate that the effect of weak local competition on store-level profit margins allows large grocery retailers to earn an additional £105–£125 million in profits a year at their larger grocery stores. This represents around 3 per cent of annual profits for the four largest grocery retailers. The additional store-level profits at mid-sized stores as a result of weak local competition may be of a similar order. Weaknesses in local competition also result in higher national prices than would otherwise be the case. The scale of the impact on national price levels arising from weak local competition, while difficult to measure, is potentially very substantial. For example, for each 0.1 per cent increase in national price levels (ie each 1p increase on a £10 shopping basket), consumer expenditure on groceries at the four largest grocery retailers increases by £80 million a year.

7. Barriers to entry or expansion in grocery retailing

7.1 Barriers to entry or expansion may constrain competition in grocery retailing by impeding the emergence or growth of competitors able to challenge the offer of existing grocery retailers. As we set out in Section 6, between 11 and 27 per cent of stores in the larger grocery stores product market, and between 10 and 22 per cent of stores in the mid-sized and larger grocery stores product market, are in highly-concentrated local markets. Accordingly, we assessed whether there are barriers to entry or expansion in these local markets as well as in grocery retailing more generally.

7.2 This section reviews the experience of store entry and expansion in UK grocery retailing to assess the likely presence of barriers to entry and expansion. It then examines three possible barriers to entry or expansion in grocery retailing. These are:

- the cost advantages that large grocery retailers have over other grocery retailers and new entrants (see paragraphs 7.14 to 7.33);

- the planning regime for grocery retailing (see paragraphs 7.34 to 7.68); and
- the control of land by large grocery retailers that may frustrate competitor entry into local markets (see paragraphs 7.69 to 7.113).

7.3 We assessed the effect of barriers to entry and expansion on different types of potential entrants. Three key types of potential entrant are:

(a) grocery retailers, such as Asda or Booths, that may compete in the relevant product market, but do not operate in the local geographic market under consideration;

(b) grocery retailers that are present in the UK but do not compete in the product market under consideration. The LADs, for example, do not currently compete in the mid-sized and larger grocery stores product market because they do not offer a full product range (see paragraphs 4.80 and 4.81), but are potential entrants; and

(c) grocery retailers with substantial operations outside the UK but which do not operate in the UK (eg the French grocery retailer, Carrefour, and the Dutch grocery retailer, Ahold).[1]

Retailer entry and expansion activity

7.4 The pattern of retailer entry and expansion in recent years, and changes in entry and expansion trends over time, provide an indication of the presence and nature of barriers to entry and expansion. The following paragraphs review:

- the rate of growth in the number of mid-sized and larger grocery stores and changes in this rate of growth;
- ownership of new larger grocery stores;
- entry rates for convenience store operators;
- entry into the UK by international grocery retailers;
- the expansion of existing larger grocery stores; and
- the persistence of highly-concentrated local markets for mid-sized and larger grocery stores.

7.5 Between 1965 and 2000, the number of grocery stores increased by 3 per cent a year. From 2000, however, the rate of growth in the number of mid-sized and larger grocery stores slowed to approximately 1 per cent a year.[2] Despite the overall slow-down since 2000, the rate of growth in the number of stores larger than 2,200 sq metres has been higher at around 3 per cent a year.[3] We do not have data that allows a direct comparison to be made with the rate of growth for stores larger than 2,200 sq metres in the period prior to 2000 and, in particular, prior to the 1996

[1]Whole Foods Market's entry into the UK through its acquisition of the Fresh & Wild chain in 2004 is an example of this type of potential entrant entering the market in practice.
[2]IGD; the number of mid-sized and larger grocery stores increased from an estimated 6,302 to 6,585 between 2000 and 2007.
[3]Verdict, *UK Grocery Retailers 2007*, December 2006, p25; between 2000 and 2006, 297 new stores larger than 2,200 sq metres opened, of which only a relatively small number were the result of existing stores being extended into this size bracket.

changes in the planning regime for grocery retailing that led to a greater focus on town centre development (see paragraphs 7.35 to 7.44).

7.6 Each of the new larger stores which has opened since 2000 is, as far as we are aware, operated by one of Asda, Morrisons, Sainsbury's, Tesco or Waitrose.[1] The lack of new store openings in the larger-stores product market by other grocery retailers indicates that they may face greater barriers to entry than these five retailers. We discuss this further in the context of planning as a barrier to new entrants (see paragraphs 7.65 to 7.68).

7.7 The Experian Goad dataset allows us to track entry by convenience stores in approximately 1,000 high streets and retail parks across the UK. Our analysis shows that 27 per cent of convenience stores surveyed in 2006 had entered in the previous two years. For independent non-affiliated convenience stores, 33 per cent of stores surveyed in 2006 had entered that sector in the previous two years. The high rate of entry observed for convenience stores suggests that barriers to entry in convenience store retailing are limited.

7.8 Since 2000, Asda, Sainsbury's and Tesco have each extended around one-quarter of their stores larger than 1,400 sq metres. The average size of each extension for these three retailers has been around 1,100 to 1,400 sq metres, representing, on average, around 40 per cent of the size of each store prior to its extension.[2] The large proportion of stores that have been extended, and the substantial size of each store extension, suggests that barriers to store expansion are limited.

7.9 We assessed whether highly-concentrated local markets for larger grocery stores and for mid-sized and larger grocery stores had persisted over time. Provided that there is sufficient demand to support an additional store, entry into highly-concentrated local markets should be attractive to retailers. This is due to the increased store-level profit margins in those markets (see paragraphs 6.52 to 6.63), and the ability conferred by these stores to set nationally determined aspects of the retail offer, such as prices, that are higher than would otherwise be the case (see paragraphs 6.64 to 6.73). Accordingly, the persistence of highly-concentrated markets is indicative of the presence of barriers to entry.[3]

7.10 We examined the experience of new entry near stores that faced few local competitors to assess whether highly-concentrated local markets have persisted over time. In 2000, there were 186 stores larger than 600 sq metres in Great Britain belonging to Asda, Morrisons, Safeway, Sainsbury's and Tesco[4] which faced no or only one competitor in the local market in which they operated (monopoly or duopoly stores). In 2006, 160 of these stores (or 86 per cent) continued to face no or only one

[1]One exception to this has been the opening of the first Whole Foods Market branded store in London in 2007. (Whole Foods Market entered the UK through its purchase of Fresh and Wild in 2004.)
[2]The majority of Asda's store extensions have provided increased floospace for both groceries and non-groceries with an emphasis on non-grocery floorspace. However, for each of Sainsbury's and Tesco only a small majority of new floor space has been for non-groceries.
[3]Entry into a new local market with no other competitors would be even more attractive but the number of larger grocery stores already in operation in the UK means that such opportunities are relatively rare.
[4]Because the CC in 2000, among other things, looked only at stores belonging to the then five largest retailers that were larger than 600 sq metres, this number is a subset of the total number of monopoly and duopoly stores that were present in Great Britain at that time. As a result, it is not comparable with the current number of monopoly and duopoly stores that we identified in Appendix 6.1. These two numbers are also not comparable for a number of other reasons, including methodological differences in identifying monopoly and duopoly stores, differences in the modelling of drive-times, differences in store size measurements, and the impact of relocations of existing stores and store extensions.

competitor (see Table 7.1).[1] The persistence of local concentration is indicative of the presence of barriers to entry in the markets in which these stores are located.

TABLE 7.1 **Status of monopoly and duopoly stores that existed in 2000 by grocery retailer**

Fascia (2000)	*Monopolies or duopolies in 2000*	*Fascia (2006)*	*2006 Monopoly*	*Duopoly*	*3 or more fascia*	*Closed*
Tesco	77	Tesco	32	38	6	1
Sainsbury's	16	Sainsbury's	3	7	5	1
Asda	7	Asda	1	4	2	0
Morrisons	4	Morrisons	0	3	0	0
		Sainsbury's	0	1	0	0
Safeway	82	Total former Safeway	43	28	6	5
		Morrisons	*23*	*22*	*5*	*0*
		Somerfield	*17*	*5*	*0*	*0*
		Waitrose	*3*	*0*	*1*	*0*
		Sainsbury's	*0*	*1*	*0*	*0*
Total stores	186		79	81	19	7

Source: CC analysis.

7.11 Insufficient demand to support an additional store may explain the persistence of concentration in some areas. In our view, however, most of the grocery stores that were identified as being monopoly or duopoly stores in 2000 and which continued to be monopoly or duopoly stores in 2006 are in areas where the local population is sufficient to support an additional store (see Appendix 7.1).

7.12 In summary, store entry and expansion activity in recent years indicates that, at a national level:

- grocery stores larger than 2,200 sq metres may face barriers to entry but the number of these stores has been growing at a faster rate than for stores of 280 to 2,200 sq metres in the period since 2000;
- retailers other than Asda, Morrisons, Sainsbury's, Tesco and Waitrose may face higher barriers to entry to opening larger grocery stores;
- operators of larger grocery stores may face barriers to the expansion of those stores, but these have not prevented a substantial proportion of these stores being extended in recent years;
- convenience stores have entered in substantial numbers in recent years indicating that there are limited barriers to entry for these stores; and
- highly-concentrated local markets have tended to persist rather than attract new entry.

7.13 In the remainder of this section we discuss three possible barriers to entry and expansion in grocery retailing, namely cost advantages for large grocery retailers, the planning regime as it applies to grocery retailing, and the control of land by large

[1]The store size threshold adopted by the CC for its analysis in 2000 means that this analysis covers all larger grocery stores owned by the then five largest grocery retailers as well as a significant proportion of their mid-sized stores. As a result, our analysis of local market developments for these stores informs our assessment of possible barriers to entry in both the larger-stores product market and the mid-sized-and-larger-stores product market. Data limitations, however, mean that we are unable to analyse separately these two product markets.

grocery retailers. We relate our analysis of these possible barriers to the store entry and expansion patterns observed in paragraphs 7.4 to 7.12.

Cost advantages for large grocery retailers

7.14 Cost advantages for large grocery retailers could act as a barrier to entry or expansion by limiting profitable entry or expansion opportunities for other grocery retailers or new entrants. We examined two possible sources of cost advantage for large grocery retailers: distribution costs, which account for a relatively small proportion of a retailer's costs, and purchasing costs, which account for approximately 60 to 70 per cent of a grocery retailer's costs.

Distribution costs

7.15 The distribution systems operated by large grocery retailers give rise to efficiency effects in the form of economies of scale[1] and economies of density.[2] These economies arise from a number of sources. Economies of density include serving a larger number of stores from each distribution centre and clustering stores in closer proximity to each distribution centre. Economies of scale include facilitating increased investment in technology aimed at improved product availability and reduced wastage, establishing specialist depots for particular types of goods, such as fresh produce or frozen foods, and engaging in further vertical integration through grocery retailers collecting goods from suppliers rather than relying on supplier delivery.[3]

7.16 These economies of density are, in principle, available to regional grocery retailers that cluster their operations around a single distribution centre as well as to large grocery retailers with multiple distribution centres. However, a grocery retailer will face cost disadvantages when opening stores in areas where it lacks a nearby distribution centre, and as a result regional grocery retailers are more likely to be constrained by this consideration than large grocery retailers.

7.17 The existing regional distribution of grocery retailers in the UK, with Sainsbury's and Waitrose stores more concentrated in the South of Great Britain and Asda and Morrisons stores more concentrated in the North, supports the view that these efficiency effects may have some significance even for the largest UK grocery retailers.[4]

7.18 New entrants have the option of entering the industry and taking advantage of the economies of density that have already been achieved by grocery wholesalers.[5] This is particularly the case for convenience store operators, but it is also a relevant consideration for regional grocery retailers operating mid-sized and larger grocery stores. For example, the regional grocery retailers, Booths and Proudfoot, are members of Nisa-Today's, a wholesaler and buying group. Further, for a new entrant

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[1]Economies of scale arise when the average cost per unit of groceries sold by a retailer decrease with the increase in the scale or magnitude of the volume being produced.
[2]These economies of density are associated with stores being located relatively close together.
[3]Vertical integration into supplier collection, commonly associated with 'factory-gate pricing', allows efficiencies to be gained through overall planning of the travel pattern of goods being delivered to distribution centres. This can, for example, reduce overall road miles through fewer vehicles carrying fuller loads.
[4]The importance of economies of density for regional grocery retailers has been borne out by the joint Managing Director of Proudfoot Group, Mr Mark Proudfoot, who stated that 'we've no plans to open any more stores at the moment—finding sites in our distribution area can be tricky', *The Grocer*, 'Shop Profile—Proudfoot Group', 10 August 2007, available at www.thegrocer.co.uk.
[5]Although new entrants may be able to benefit from economies of density that are achieved by wholesalers, wholesalers would charge a mark-up to the new entrant that would not be incurred by a grocery retailer with a vertically-integrated wholesaling function.

into grocery retailing that was only opening one store, or a small number of stores, the smaller initial scale of its operations, and the reduced need to incur the high fixed costs of a large distribution centre, would to some extent offset the cost advantages that other retailers derive from economies of density and a vertically-integrated wholesaling function.

7.19 The economies of scale identified in paragraph 7.15—namely those arising from retailer investment in technology, specialist distribution centres, and vertical integration into goods collection—are likely to represent cost advantages that, in large part, may be available only to large grocery retailers. Convenience store operators and regional grocery retailers are able to benefit from the economies of scale achieved by the grocery wholesaling sector. However, we are only aware of large grocery retailers vertically integrating into supplier collection.

7.20 In conclusion, the barriers to entry and expansion arising from the economies of density associated with the distribution systems operated by grocery retailers are limited, but may act to impede entry into new regions by both regional grocery retailers and, to a lesser extent, large grocery retailers. Economies of scale arising from grocery retail distribution systems are likely to represent a cost advantage to large grocery retailers, but would in part at least be mitigated by the presence of the grocery wholesaling sector. Further, the significance of any cost advantage that large grocery retailers may have as a result of their distribution systems, in the context of their overall costs, is not clear. Any advantage in purchasing costs (see paragraphs 7.25 to 7.27) is likely to be of much greater overall significance given that these form approximately 60 to 70 per cent of total costs for grocery retailers.

Purchasing costs

7.21 A further source of cost advantage for large grocery retailers compared with other grocery retailers and new entrants is the terms on which they are able to purchase goods from suppliers. We set out in paragraphs 5.19 to 5.43 and Appendix 5.3 the results of our supplier pricing analysis.

7.22 This analysis of average supplier prices indicates that:

- small wholesalers have a significant disadvantage in purchasing terms relative to other wholesalers and large grocery retailers;
- Tesco has a significant advantage in purchasing terms relative to other large grocery retailers and wholesalers;
- Asda, Morrisons and Sainsbury’s also have a purchasing terms advantage relative to other large grocery retailers and wholesalers, but to a lesser extent than Tesco; and
- other large grocery retailers and large wholesalers pay higher prices than the four largest grocery retailers but pay similar prices as each other.

The following paragraphs consider the significance of these purchasing differentials as a barrier to entry or expansion.

7.23 We assessed how the purchasing disadvantage of small wholesalers relative to other wholesalers and grocery retailers might affect convenience store operators that use small wholesalers. As a result of paying higher wholesale prices, these convenience store operators might, in principle, find it difficult to find profitable entry or expansion opportunities. However, these operators will, in most cases, have the option of using alternative wholesalers or affiliating to a different symbol group that has better purchasing terms. Further, small wholesalers have the option of aggregating further, for example through forming larger buying groups, so as to address any disadvantage in buying terms. As a result, we do not find that the purchasing terms differential for small wholesalers creates a barrier to entry or expansion for their convenience store customers.

7.24 As explained in paragraph 5.41, Tesco has a significant advantage in purchasing terms relative to other large grocery retailers and wholesalers. We examined whether Tesco, as a result of its purchasing cost advantage, might be willing to pay higher prices for landsites than its competitors due to a higher level of expected returns, and whether this advantage might increase in size were Tesco to open a significant number of additional stores. Three factors led us to the view that Tesco's purchasing cost advantage does not currently provide an insurmountable barrier to entry or expansion by other large grocery retailers.

7.25 First, the expected profits from a store will also be influenced by a range of other factors. Tesco's purchasing cost advantage may not be sufficient for it always to outbid other grocery retailers. In any event, in practice, we observed relatively few auction-type processes where grocery retailers compete head to head for the acquisition of a landsite or development opportunity. Grocery retailers often have a long-term relationship with a developer for the purpose of identifying and developing sites. Further, local authorities in choosing a grocery retailer as a development partner may look for attributes, such as the nature of the proposed development, that go beyond the amount that the grocery retailer is willing to pay for a site.

7.26 Second, evidence from the pattern of site acquisitions is that other grocery retailers continue to acquire sites despite Tesco's purchasing cost advantage. Each of the four largest grocery retailers has a substantial pipeline of land bank sites that implies further new store openings in the future.

7.27 Third, subject to some year-on-year variations, Tesco's advantage in purchasing terms has not grown since 2003 despite its increase in total sales and market share. This seems consistent with the size advantage of grocery retailers not growing beyond a certain level. That is, Tesco may be approaching the point at which buying advantages associated with scale are becoming exhausted. As a result, it is possible that at least some of Tesco's buying advantage over other retailers could be eroded without those retailers needing to achieve the same scale as Tesco.

Conclusion on cost advantages as a barrier to entry and expansion

7.28 We examined two possible sources of cost advantage for large grocery retailers, namely distribution costs and purchasing costs, and their implications as a barrier to entry or expansion for convenience store operators, regional grocery retailers, other large grocery retailers and new entrants.

7.29 Many convenience store operators are customers of large wholesalers that buy from suppliers on terms that are similar to those of large grocery retailers (other than the four largest). These large wholesalers have well-developed distribution systems that may face only relatively small-scale disadvantages compared with large grocery retailers. Convenience store operators that are customers of smaller wholesalers that pay higher prices to suppliers have the option, in many cases, of transferring their business to larger wholesalers. Wholesalers also have the option of addressing any disadvantage in buying terms by joining a larger buying group.

7.30 Further, to the extent that there is a cost disadvantage that flows through to the prices charged by convenience stores, any assessment of the significance of this price effect needs to take into account the convenience store retail offer compared with mid-sized and larger grocery stores. In particular, the longer opening hours and, often, the greater accessibility of these stores allow them to attract customers despite generally charging higher prices than mid-sized or larger grocery stores.

7.31 In conclusion, we do not find that convenience store operators currently face a barrier to entry or expansion that arises from any cost disadvantage relative to other grocery retailers. This is consistent with our observations of moderate growth in the number of convenience stores (see paragraph 5.5) and the significant rate of new entry for convenience stores (see paragraph 7.7).

7.32 Similarly, for regional grocery retailers and new entrants, the grocery wholesaling sector mitigates any cost disadvantages in relation to distribution and purchasing costs and minimizes barriers to entry and expansion. Regional grocery retailers and, to a certain extent, some large grocery retailers may, however, face barriers to entry or expansion in new regions due to the economies of density that existing retailers in those areas are able to derive from their distribution systems. We have not, however, identified any particular region of the UK where this might give rise to a finding that such a barrier was having an AEC.

7.33 All grocery retailers and wholesalers face a purchasing cost disadvantage relative to Tesco. Given the importance of purchasing costs as a proportion of overall costs, this advantage may well be reflected in total unit costs. We conclude, however, that Tesco's purchasing cost advantage does not currently represent an insurmountable barrier to entry or expansion by other grocery retailers, and we do not find that this cost advantage gives rise to an AEC.

Planning regime as it applies to grocery retailing

7.34 The planning regime for grocery retailing is the second of three areas that we examined as a possible barrier to entry and expansion in grocery retailing. We review the impact of the planning rules on the extent to which entry and expansion can take place, and the conduct of large grocery retailers in their interactions with the planning system and the effect of this on entry and expansion by competing large grocery retailers and others.

Planning rules and their impact on entry and expansion

7.35 The purpose of the planning system is to control and shape development to meet a broad range of economic and social objectives. It aims to promote the orderly growth and development of town centres and the provision of a wide range of services in a pleasant and widely accessible environment. These specific objectives are set in the context of wider objectives regarding economic growth, regeneration, social inclusion, sustainability and good design.

7.36 In support of these objectives, the planning regime as it applies to grocery retailing seeks to focus grocery retail developments in town centres, and to this end puts in place a number of requirements that must be met before out-of-centre development that is not provided for in an LPA's development plan can take place.[1] These include

[1]These are set out in Planning Policy Statement 6 (PPS6)—Planning for Town Centres, which is one of a series of notes prepared by the Secretary of State to set out government guidance on the interpretation of planning policy with regard to retail developments and their relationship to the town centre.

a requirement that no suitable location in the primary shopping area is available (the sequential test),[1] there is a demonstrated 'need' for the development (the need test), and the development is of an appropriate scale and will not have an undue impact on existing retail centres (the retail impact assessment). In May 2007, the Government announced that it would replace the need and impact tests with a new test that will have a strong focus on its town-centre-first policy, and which will promote competition and improve consumer choice, avoiding the unintended effects of the current need test.[2] Appendix 7.2 sets out further details on the planning system as it relates to grocery retailing.

7.37 An inevitable consequence of a plan-led system that seeks to meet the broad range of objectives set out in paragraph 7.35 is that grocery retailers may not always be able to open a new larger grocery store in the location of their choice. That is, the planning system will, quite deliberately and appropriately for the purposes of meeting its objectives, act—to some extent—as a barrier to entry and/or expansion.

7.38 The planning regime acts as a barrier to entry or expansion primarily for larger grocery stores. This is because, in general, it is easier to secure suitable sites for mid-sized grocery stores or convenience stores in those areas where planning consent is already in place or where planning requirements are significantly less onerous, in particular in town centres.

7.39 A number of grocery retailers told us that the increased town-centre focus since 1996 had led them to focus on developing smaller stores in town centres and edge-of-centre locations. Tesco told us that it had increased the range and variety of store formats to gain access to a greater number of potential sites. Sainsbury's told us that 'since the 1996 change to retail policy in PPG6,[3] retailers prepared to accept the policy focus of retailing on centre and edge-of-town centre sites of an appropriate scale have not been unduly constrained by the planning system'. To the extent that the planning regime has encouraged convenience and mid-sized stores rather than larger grocery stores through impacting on the development strategy of grocery retailers, this is a further indicator that the planning regime represents a barrier to entry for larger grocery stores.

7.40 In practice, a number of retailers see the need test, rather than any of the other tests set out in paragraph 7.36, as the key barrier to the development of new larger grocery stores. Sainsbury's cited the town of Braintree in Essex where the local development plan states that there is 'no capacity for additional convenience goods floorspace up to 2021'. Sainsbury's also suggested that a similar situation might arise in south-west Bradford in Yorkshire if planning permission was given to Tesco for one new and one replacement store. Asda considered that the need test directly restricted competition and had the unintended consequence of favouring incumbents in local markets. Tesco, however, stated that it knew of no case where a planning application had failed solely because of the lack of identifiable need.

7.41 Our own survey of LPAs indicates that 62 per cent had quantified a need[4] for additional floorspace for the retailing of convenience goods (ie consumer goods purchased on a regular basis, including food, toiletries and cleaning products) in their

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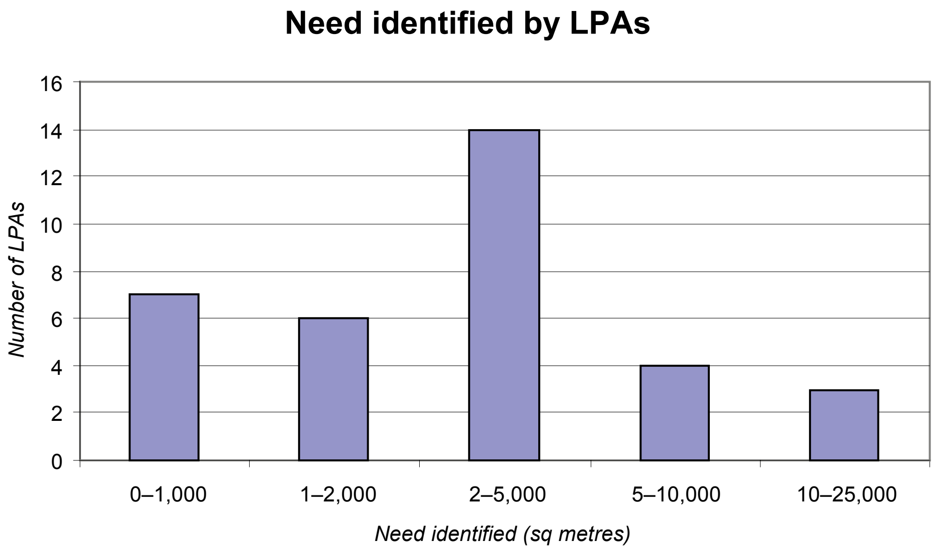
[1]The primary shopping area is defined in PPS6 as the area where retail development is concentrated. It is closely related to (and in practice used interchangeably with) the town centre classification, which PPS6 states is a defined area, including the primary shopping area and areas of predominantly leisure, business and other main town centre uses within or adjacent to the primary shopping area.
[2]*Planning for a Sustainable Future:* White Paper, 21 May 2007.
[3]PPG6 was the precursor of PPS6.
[4]In accordance with the method advised in PPS6, the principal focus is upon quantitative, rather than qualitative, assessments of need (see PPS6, paragraph 2.33).

local development plan. The average area of identified need was 4,600 sq metres (with a median of 2,500 sq metres). The majority of LPAs that did not have an identified need for additional floorspace for the retailing of convenience goods were those that did not have an up-to-date development plan. However, a significant minority of LPAs (18 per cent of our sample or ten LPAs) had an up-to-date retail development plan and concluded that they did not have a need for any new retail convenience goods floorspace over the period of the plan.

7.42 In a number of cases where LPAs had an up-to-date retail development plan, the level of need that had been identified was relatively small and it was not clear that it would be enough to justify a new larger grocery store. Figure 6.1 shows the distribution of identified 'need' by number of LPAs.

7.43 As we set out in paragraph 7.36, the need test is only one component of a series of tests that constrain retail development for the purposes of meeting broader planning system objectives. It is not clear to us that the need test, on its own, acts as a barrier to entry or expansion over and above the other components of the planning regime that apply to grocery retailing. We understand, however, the concerns that were raised about the need test in the Barker Review of Land Use Planning (an independent review of land use planning for the Government that focused on the link between planning and economic growth).[1] These were that incumbents may find it easier to expand incrementally while prospective local entrants fail at any one time to demonstrate sufficient need for a one-off increase in floorspace. In any event, as we set out in paragraph 7.36, the Government has announced its intention to abolish the need test and replace it with a new test that will have a strong focus on the town-centre-first policy, and which will promote competition and improve consumer choice, avoiding the unintended effects of the current need test.

FIGURE 7.1



Source: CC survey of selected LPAs.

7.44 In conclusion, the planning system for the purposes of meeting its broad-based objectives constrains new entry by larger grocery stores. These constraints are less significant for mid-sized grocery stores and convenience stores given that suitable locations that are not subject to planning restrictions are more easily found.

[1]Barker Review of Land Use Planning, Final Report—Recommendations, December 2006, paragraph 1.32.

Costs and risks associated with securing planning permission

7.45 The planning system imposes both costs and risks on developers of sites for grocery retailing. These costs and risks take the form of:

- the time required to assemble a site likely to secure planning permission and then to achieve planning permission for that site;
- the direct costs of making a planning application as well as the cost of financing any agreements with the LPA that are necessary to secure planning permission; and
- the risk of a planning application being rejected and the costs associated with the application not being recoverable through the new development.

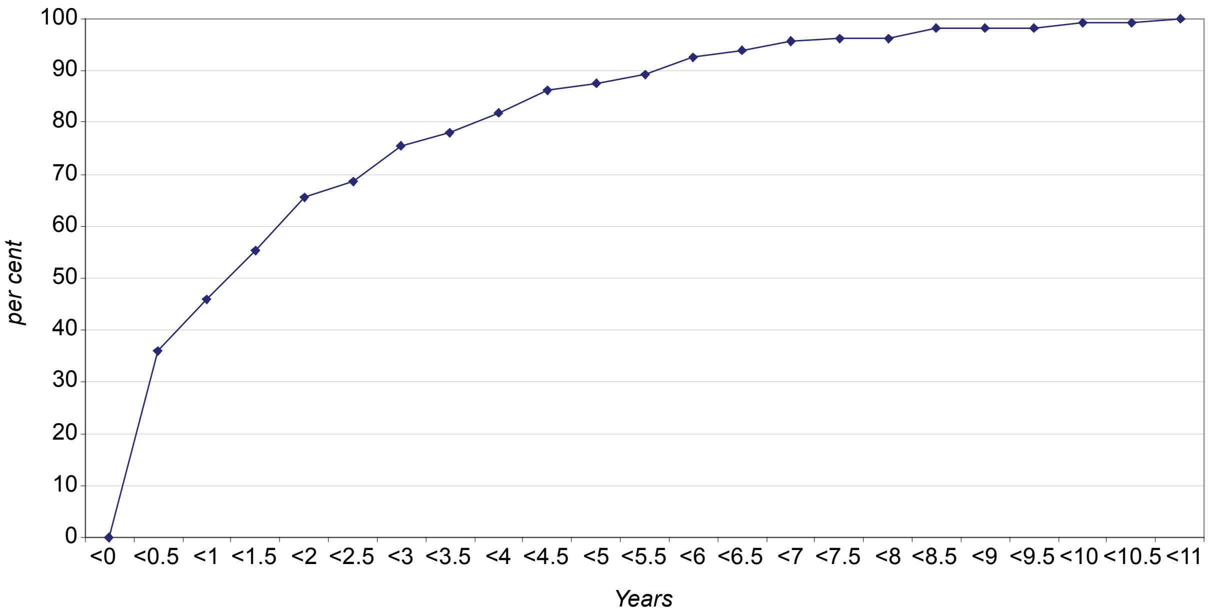
Time required to assemble a site and secure planning permission

7.46 The planning regime, as we set out in paragraphs 7.35 to 7.43, seeks to focus grocery retailing development in town centres. Developing new stores in town centre locations may, however, require the assembly of several smaller parcels of land, which can take time and result in the retailer incurring significant holding costs.

7.47 Figure 7.2 provides an indication of the time required for site assembly, based on information from the four largest grocery retailers. In around half of these cases, it took more than 18 months to assemble the site, and in some cases the process has been extremely lengthy. In around 20 per cent of cases, site assembly has taken longer than four years.

FIGURE 7.2

Distribution of multi-parcel site assembly duration

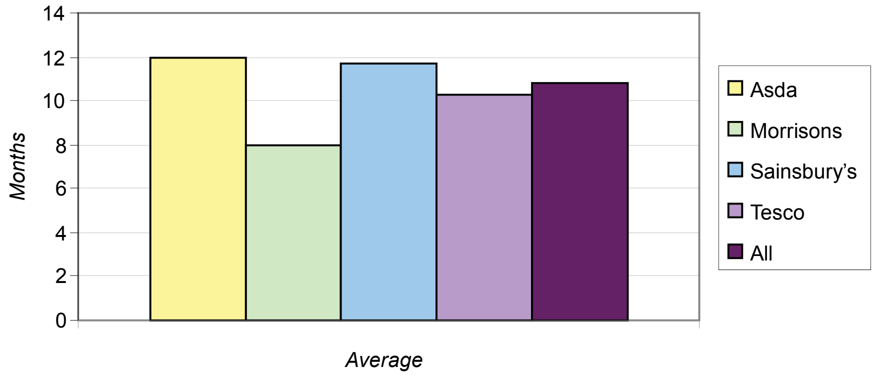


Source: CC analysis of 233 multi-parcel sites purchased by the four largest grocery retailers since 1996.

7.48 In addition to assembling a site, a grocery retailer (or other developer) must apply for planning permission for that site. Information from the four largest grocery retailers shows that it takes, on average, 10 to 12 months from the time a full planning application has been submitted to the granting of planning permission (see Figure 7.3). The impact of this time requirement can, however, be mitigated by applying for permission prior to completing the assembly of a landsite, although this approach is not without its risks.

FIGURE 7.3

Average planning time for full planning application, by retailer



Source: CC analysis.

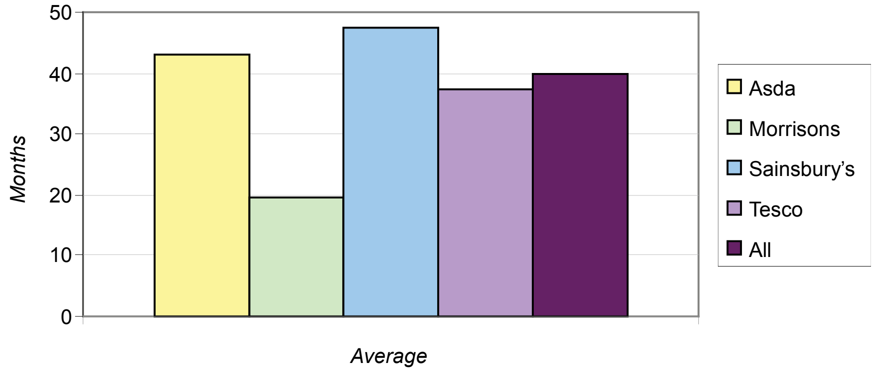
7.49 In around one-quarter to one-half of all planning applications by the four largest grocery retailers, the retailer, first, submits an outline application, covering the size of the proposed development but without detailed drawings. Once this is accepted, the retailer submits the specific details of the development such as the building design, the external appearance, means of access and landscaping. This two-stage process takes, on average, about 40 months (see Figure 7.4), which is considerably longer than submitting a full planning application. However, by submitting an outline application, a grocery retailer is able to defer some of the costs associated with a full application until it is more confident that the application is likely to succeed.

7.50 Where a planning application is 'called in' for a public inquiry,[1] additional time will be required before planning approval can be secured. Each year, around five applications for grocery development are called in or otherwise decided by the Secretary of State. Planning applications are called in if they raise issues of more than local importance (eg a conflict with national planning policy, or a development with wide effects beyond the immediate locality). A call-in will typically add around 12 months to the planning process, although more complex cases may add up to 18 months.

[1]Although most planning applications are decided by LPAs, the Secretary of State for Communities and Local Government has the power to call in an application for decision. The Secretary of State normally exercises this power only when issues of more than local importance arise from the application.

FIGURE 7.4

Average planning time for a two-stage planning application, by retailer



Source: CC analysis.

7.51 In summary, the entry of a new larger grocery store in a local market is likely to take at least two years and, in many cases, considerably longer. This will include assembling a site, obtaining planning permission and building a new grocery store with proper access and amenities.

Direct costs associated with planning applications and planning agreements

7.52 A planning application for a new larger grocery store will impose significant costs on a retailer or developer. In addition to building designs, a planning application will also include a number of supporting analyses from the applicant, such as a need assessment and a retail impact assessment for developments in out-of-centre locations (see paragraph 7.36). The applicant may also need to retain planning consultants and others to ensure that traffic, environmental and other considerations are appropriately addressed.[1] The fees for a planning application are capped at £250,000[2] and other costs associated with a planning application may also be significant (eg a need assessment could cost more than £50,000).[3]

7.53 In making a planning application, a grocery retailer may also need to negotiate section 106 (planning obligations) and section 278 (transport planning) agreements with the local authority, and ultimately, assuming the application is approved, finance or provide for the various components of any agreement.[4] A review of planning applications by the four largest grocery retailers between 2000 and 2006 shows that the proportion of planning permissions for new larger grocery stores with an

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[1]To mitigate the costs associated with making a planning application that is not consistent with the local development plan, a grocery retailer might seek to influence the drafting of the local development plan. However, this strategy carries its own set of costs. Our survey of LPAs indicates that nearly 90 per cent of LPAs consider that grocery retailers have some level of involvement in the formulation of the local development plan. However, this involvement is not enough to generate sufficient opportunities for out-of-centre developments to obviate the need to make planning applications that are not consistent with the local development plan.

[2]The Town and Country Planning (Fees for Applications and Deemed Applications) (Amendment) (England) Regulations 2008, Schedule 1, Part 2, states: '(v) where the area of gross floor space to be created by the development exceeds 3750 square metres, £16,565; and an additional £100 for each 75 square metres in excess of 3750 square metres, subject to a maximum in total of £250,000'. For a store with gross floor space of 10,000 sq metres, planning fees would be around £25,000.

[3]Barker Review of Land Use Planning, Final Report—Recommendations, December 2006, paragraph 1.31.

[4]In certain circumstances it may be necessary for applicants to enter into agreements or undertakings with an LPA ('planning obligations') for planning permission to be granted. Planning obligations (or 'section 106 agreements' made under section 106 of the Town and Country Planning Act 1990) may restrict development or use of land; require operations to be carried out in, on, under or over the land; require the land to be used in any specified way; or require payments to be made to the LPA either in a single sum or periodically. Section 278 agreements are agreements for private sector funding of works on the strategic road network which are necessary for planning permission to be granted.

associated section 106 agreement with a defined cost[1] ranged from 40 to 65 per cent. Within this range, [✄] (65 per cent) and [✄] (62 per cent) have a higher proportion of planning permissions with section 106 agreements, while [✄] (54 per cent) has a somewhat smaller proportion and [✄] has the smallest (40 per cent) (see Table 6.3). The average cost for those section 106 agreements with a defined cost (as opposed to agreements to provide, for example, a facility that is not explicitly costed) varies from £320,000 for [✄] to £805,000 for [✄].[2]

TABLE 7.2 **Section 106 agreements by retailer for new larger grocery stores over 1,400 sq metres net sales area**

	Asda	*Morrisons*	*Sainsbury's*	*Tesco*	*Total*
Number of new larger grocery stores					262
% with quantified s106 amount			✄		52
Average cost (£'000)					541

Source: CC analysis of grocery retailers' data.

Note: Analysis covers period between January 2000 and July 2006.

7.54 Further costs may arise from a planning application being called in and the retailer needing to engage in a public inquiry process. Planning decisions may also be subject to appeal by third parties, or grocery retailers may wish to appeal the decision of the planning authority. This may result in substantial legal costs for a grocery retailer.[3]

7.55 Concerns have also been raised with us regarding the effectiveness of LPAs in managing planning applications and, to the extent that this is true, this would impose further costs on applicants. We were told that LPAs are sometimes:

- under-resourced ([✄]); or
- lacking sufficient expertise to deal with grocery retailing applications ([✄]).[4]

7.56 In conclusion, securing planning permission for a new larger grocery store imposes significant costs on a retailer in terms of both the time and cost associated with securing a site that is likely to be granted planning permission and the direct costs associated with the planning application. There is also a risk for a retailer that a planning application is not successful and many of the costs associated with assembling the site and pursuing planning permission may not be recoverable.

7.57 Large grocery retailers with substantial experience of working within the planning process are in a much better position to mitigate or absorb the costs and risks associated with the development of new larger grocery stores than regional grocery retailers, or new entrants to the industry, such as international operators without a UK presence. This is consistent with our observation in paragraph 7.6 that, with one

[1]There are a significant number of section 106 agreements that do not appear to involve payment of an explicit amount of money but involve a wide range of commitments. Examples of such commitments are to keep another store open or change the use of an old store, and the development of travel or car-park management schemes. Many of these involve a cost to the retailer but the cost is not defined in the section 106 agreement. These were not included in our calculations.
[2][✄] told us that this figure included wider section 106 agreements entered into by a developer where an [✄] store was only part of the development.
[3]Netto, for example, told us that it did not generally dispute planning decisions as it regarded the cost as too high for its business model.
[4]The CLG, however, told us that the performance of LPAs in approving planning applications was improving, and that 68 per cent of major retail planning applications are dealt with within 91 days (13 weeks). Planning data submitted by grocery retailers shows that in the period since 2000 it has taken an average of 334 days (median 182 days) to obtain planning approval.

exception of which we are aware, each of the new larger grocery stores opened since 2000 is operated by one of Asda, Morrisons, Sainsbury's, Tesco or Waitrose.

Retailer interaction with the planning system

7.58 We examined the way in which grocery retailers interact with the planning system which has the effect of frustrating the opening of new stores by rivals. Two specific issues were raised with us in this context. These were, first, grocery retailers objecting to competitors' planning applications, and second, the extent to which store extensions by incumbent grocery retailers are able to impede competitor entry.[1]

FIGURE 7.5

Objections to competitors' planning applications by grocery retailer, 2000 to 2006

[✂]

Source: CC analysis of grocery retailers' data.
Note: Success was assessed based on the immediate outcome of the planning application so that *(a)* withdrawn/called in means objector won (although we recognize that for a call-in, permission may later be granted by the Secretary of State); *(b)* granted with conditions means objector lost. In some cases there could be more than one competitor objecting to a planning application, in which case the same criteria for success are applied to both objectors. The information submitted suggests, however, that there are only a few cases where there has been more than one company objecting to a competitor application. Also the analysis does not take account of whether other factors besides an objection may have caused an application to be rejected.

7.59 The frequency of objections to competitors' planning applications by a number of large grocery retailers since 2000 is shown in Figure 7.5. With the exception of one grocery retailer, [✂], grocery retailers have objected in total to some 9 per cent of grocery retail planning applications since 2000. With the inclusion of [✂], this increases to 34 per cent.

7.60 With the exception of [✂], objecting to competitors' planning applications appears to be on a relatively small scale. In around one-third to one-half of all cases, planning applications were withdrawn or called in for a further inquiry following an objection by an incumbent grocery retailer (see Figure 7.5). However, it is not possible to assess the significance of any of these objections in terms of the final planning outcome. That is, the planning application may have been withdrawn or rejected for reasons unrelated to the objection by the incumbent grocery retailer.

7.61 Asda told us that store extensions could impede the opening of new stores by rivals in two ways. First, an incumbent grocery retailer could respond to a specific planning proposal for a new store by a rival retailer with its own proposal for a store extension that would meet any 'need' for additional floorspace that had been identified by an

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[1]Another aspect of the concerns that have been raised with us is the extent to which grocery retailers are able to influence the planning system so as to generate new entry opportunities that would not have otherwise have been available. The numerous potential interactions between local authorities and grocery retailers within the planning system, and more generally in terms of local development, provide many opportunities for grocery retailers to influence local decision-making. For example, grocery retailers can: make submissions on local development plans as part of public consultation processes; use planning consultants and other firms to lobby local decision-makers in relation to both local development plans and individual planning decisions; enter into development agreements with local authorities to build new stores on land owned by the local authority; encourage local authorities to use compulsory purchase orders to obtain land holdings from rival retailers and others; negotiate section 106 agreements with local authorities as part of a planning application; and threaten to appeal against LPA decisions. We recognize that grocery retailers' ability to influence local decision-making so as to gain entry opportunities that would not otherwise occur may be a matter for concern in the context of the overall objectives of the planning regime. However, from a competition perspective, our major concern is in relation to those actions that may lead to the exclusion of rivals from a local market.

LPA. Second, and in Asda's view more importantly, incumbents understood that on-going expansion including using extensions in local areas (irrespective of any immediate threat of entry) tended to reduce the prospect of future competitive entry as a result of the need test mechanism. Asda told us that the planning regime facilitated this behaviour because extensions passed the need test more easily than new stores and they were also more likely to pass the retail impact assessment. This is consistent with our finding in paragraph 7.8 that a large proportion of stores have been extended in recent years.

7.62 More specifically, Asda told us of planning applications for new stores in Chesterfield in Derbyshire, Salisbury in Wiltshire and Worthing in West Sussex that were rejected following proposals by competing retailers to extend their stores.[1] Having reviewed these cases, however, we found that other considerations, besides that of whether a new build or extension was preferable, formed part of the planning decision. Further, Morrisons and Tesco both told us that the timescales involved in preparing and submitting an application were such that it was not realistic to submit an application for an extension in response to a competitor application.

7.63 Nevertheless, [✂] told us that in [✂], in response to encouragement by the relevant LPAs, it had submitted applications to extend two stores in response to the possibility of out-of-town superstore developments. Further, one-third of respondents to our LPA survey indicated that they were aware, or had reason to believe, that competitors submitted planning applications in response to a planning application made by a competitor.

7.64 In conclusion, objecting to competitors' planning applications does not appear to be particularly widespread or a significant matter of concern in terms of barriers to entry or expansion. However, the relative ease of gaining planning permission for store extensions, as evidenced by the number of store extensions that we observe, combined with the need test, is likely to provide incumbent retailers with an advantage over new entrants in providing new grocery retailing floorspace in a local market.

Conclusion on the planning regime as a barrier to entry and expansion

7.65 In conclusion, the planning system, in pursuing the broad-based objectives for which it is intended, necessarily constrains new entry by larger grocery stores. It also has the effect of increasing the time for new larger grocery store entry to take place due to the need to assemble sites likely to be granted planning permission as well as the time required by LPAs to consider planning applications.

7.66 The costs associated with site assembly and submitting a planning application, and the risk of planning permission not being granted, mean that the existing large grocery retailers with substantial experience of the planning system are in a better position to mitigate or absorb these costs and risks than regional grocery retailers and new entrants to the industry, such as international operators without a UK presence.

7.67 The planning regime places more limited constraints on the extension of existing stores by grocery retailers compared with new larger grocery store entry. An

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[1]Asda told us that in Chesterfield, Sainsbury's and Tesco both submitted planning applications to extend their existing stores shortly after Asda's application for a new store, but that Sainsbury's later withdrew its application, while Tesco's application was approved and Asda's application for a new store was rejected. Asda told us that in Salisbury and Worthing, Tesco submitted planning applications to extend its existing stores shortly after Asda had submitted a planning application for a new store, and in both cases, Tesco's application was approved and Asda's application was rejected.

incumbent grocery retailer, by extending its store, will make new larger grocery store entry by a rival grocery retailer more difficult.

7.68 Finally, the planning regime for grocery retailing places limited barriers on entry or expansion by mid-sized grocery stores and convenience stores.

Control of land as barrier to entry or expansion

7.69 The control of land by large grocery retailers is the third area that we examined as a possible barrier to entry and expansion. In this section we first analyse whether grocery retailers are engaging in 'land banking' as a means of frustrating competitor entry, and second, examine their control of land more generally in highly-concentrated local markets.

Grocery retailer land bank sites

7.70 Before making a reference to us the OFT received a number of complaints that the four largest grocery retailers had built up significant land bank sites with the intention of restricting entry. The OFT concluded that there were reasonable grounds for suspecting that the issues around land holdings that it had identified were features that prevent, restrict or distort competition in the market for the supply of groceries by retailers in the UK.[1]

7.71 In light of the complaints received by the OFT as well as complaints made directly to us, we assessed whether grocery retailers were engaging in landbanking as a means of frustrating competitor entry. In the following paragraphs we assess:

- the extent and distribution of grocery retailers' land bank sites;
- the time taken by grocery retailers to develop land bank sites into new stores; and
- the financial incentives for holding undeveloped land as a barrier to entry by a rival retailer.

Extent and distribution of grocery retailers' land bank sites

7.72 Land banks are sites, or collections of sites, owned by grocery retailers that are potentially available for development into retail stores or additional retail space. The four largest grocery retailers in the UK owned approximately 520 land bank sites as of July 2006.

[1]OFT, *The Grocery Market—The OFT's Reasons for making a reference to the Competition Commission*, May 2006.

TABLE 7.3 **Total land bank sites, by retailer**

	Land bank
Asda	✂
Morrisons	
Sainsbury's	
Tesco	
Total	520

Source: CC.

Note: Controlled landsites as of 1 July 2006.

7.73 Of the four largest grocery retailers, [✂] has the largest proportion of land bank sites. Other large grocery retailers also control a large number of land bank sites; Somerfield and M&S, in particular, hold nearly [✂] land bank sites between them.

7.74 We looked at the distribution of land bank sites for the four largest grocery retailers relative to areas in which they have a strong local market position. We did not find a pattern of land bank sites in highly-concentrated areas. This indicates that the land bank sites held by grocery retailers, in the main, represent a pipeline of future development activity rather than strategic holdings aimed at impeding entry by competing grocery retailers.[1]

Time taken by grocery retailers to develop land bank sites

7.75 We examined the time for which grocery retailers hold land bank sites without developing them. Holding land without developing it imposes costs on a retailer, and we might expect that a retailer would only do this if it gave it a benefit that offset the cost of holding undeveloped land. One way in which this benefit might be realized is through the creation of a barrier to entry to a local market.

7.76 Our analysis focused on two periods: the period that grocery retailers are holding land bank sites prior to applying for planning permission, and the period between gaining planning permission and opening a new store. In relation to the first period, our analysis shows that for [✂] more than 63 per cent of completed assembly landsites[2] currently in its possession have been held for more than two and a half years since acquisition or completion of site assembly without an application for planning permission being made. This compares to a historical benchmark in our analysis for the four largest grocery retailers of 19 per cent.[3] The equivalent figure is 50 per cent for [✂] and 40 per cent for [✂]. Only [✂] appears to be applying for planning permission at a rate that is faster than has historically been the case for the four largest grocery retailers.

7.77 In relation to the second period, each of the four largest grocery retailers has a number of sites where more than two and a half years have elapsed between the granting of planning permission and the opening of a store. However, none of the four largest grocery retailers appears to be holding sites, on average, for longer than has historically been the case in terms of the period between the granting of planning permission and the opening of a new store.

[1]The majority of controlled landsites held by the eight large grocery retailers are in local areas where they do not have a store. For example, [✂] per cent of Tesco's and [✂] per cent of Asda's controlled landsites are in local areas where they do not operate any mid-sized or larger grocery stores.
[2]We consider that a landsite is a completed assembly landsite once all land parcels necessary for the development have been acquired.
[3]The benchmark is calculated from those sites for which a planning application was submitted during 1996 to 2004, but which were not fully assembled after 2004 (see Appendix 7.3).

7.78 The lengthier times for which grocery retailers are holding completed land bank sites undeveloped prior to applying for planning permission could indicate that this land is being held for purposes other than development, such as the exclusion of a rival grocery retailer from a local market.

Financial incentives for land holdings

7.79 The extent to which a grocery retailer would be willing to purchase land so as to frustrate competitor entry will be influenced by the cost of buying and holding land undeveloped as well as the potential cost in lost revenues if entry by a competitor were to take place on that land.

7.80 Holding land undeveloped as a land bank site, however, is not the only means of preventing its use by a rival grocery retailer. Further, holding land undeveloped seems a relatively costly strategy compared with the alternatives of selling that land with a restrictive covenant, developing the land and leasing it to a third party, or holding only a small parcel of the total landsite as a so-called ‘ransom strip’. (We discuss these means of controlling land further in paragraphs 7.86 to 7.101.) It is worth noting, however, that these alternative controlled land strategies are not themselves costless. Leasing land to a non-grocery retailer or selling it with a restrictive covenant preventing grocery retailing may also impose a cost on a grocery retailer as, in many cases, the most profitable use of a landsite will be for grocery retailing.

Conclusion on land banks as a barrier to entry and expansion

7.81 In conclusion, we do not find that grocery retailers are engaging in the holding of undeveloped land (or landbanking) as a strategy to impede the entry by rival grocery retailers into local markets. The distribution of land holdings held by grocery retailers shows that these are, in the main, in areas where the grocery retailer does not have a strong presence. The four largest grocery retailers are taking longer to develop land into stores than has been the case in the past, and while this may be consistent with a landbanking strategy, it may also be explained by other factors such as time preparing planning applications. Finally, holding land undeveloped as a land bank seems a relatively expensive means of controlling land for the purposes of impeding competitor entry compared with other means of controlling land, such as leasing land to third parties or selling it with a restrictive covenant. We discuss these other practices in the following paragraphs.

Controlled land in highly-concentrated local markets

7.82 This section examines the extent to which individual landsites controlled by grocery retailers may be acting as barriers to entry in highly-concentrated local markets and thus facilitating the persistence of weak competition in these areas.

7.83 In addition to the undeveloped land (or land bank sites) that we discuss in paragraphs 7.72 to 7.74, we also take into account in our analysis three other means by which grocery retailers can control land. These are: land owned or leased by a grocery retailer and leased or sub-leased to a third party; restrictive covenants; and exclusivity arrangements. When a grocery retailer with a strong position in a highly-concentrated local market exercises control over a landsite, it makes entry more difficult for a competing retailer allowing the incumbent retailer to continue to benefit from its position.

7.84 The number of controlled landsites for the eight largest grocery retailers broken down into the categories discussed in paragraph 7.83 is shown in Table 7.5. [✂] has the largest number of land bank sites, while [✂] leases the most sites to third parties. Overall, [✂] controls the largest number of landsites, double that of [✂].

TABLE 7.4 **Controlled landsites, by retailer**

	Land bank sites	*Third party lease*	*Restrictive covenants (retailer)*	*Exclusivity arrangement*	*Total controlled landsites*
Asda					
Morrisons					
Sainsbury's					
Tesco			✂		
Waitrose					
Somerfield					
CGL					
M&S					
Total	721	216	212	87	1,272

Source: CC analysis.

Note: The [✂] land bank sites for M&S includes both land bank sites and third party lease sites.

7.85 The following paragraphs describe the various means by which grocery retailers are able to control land, and set out our analysis of controlled land as a barrier to entry in highly-concentrated markets.[1]

Mechanisms for controlling land

Land bank sites

7.86 Land banks are sites owned by grocery retailers and which are potentially available for development into retail stores or additional retail space. Each of the four largest grocery retailers in the UK has a considerable number of land bank sites (see paragraphs 7.72 to 7.74).

Leases and sub-leases to third parties

7.87 An alternative to holding land undeveloped as a barrier to entry is to own or lease land and grant a lease or sub-lease to a third party which is not a grocery retailer. As with undeveloped land, leases and sub-leases to non-grocery retailers may restrict the availability of sites suitable for grocery retailing.

Restrictive covenants

7.88 A restrictive covenant is a restriction typically imposed on the sale of freehold land that limits the future use of that land.[2] (We separately assess restrictive clauses in

[1] We did not review individual landsites that are not in highly-concentrated local markets as these are less likely to be areas where the incumbent has a strong local position that is worth protecting. M&S provided us with a list of restrictive covenants and exclusivity arrangements which in its view had affected M&S's ability to enter different local markets. We examined two of these restrictive covenants and exclusivity arrangements, which we identified as being in highly-concentrated local markets, as part of our in-depth controlled land analysis—see paragraphs 7.102 to 7.113.

[2] The term restrictive covenant is most appropriate to land law in England and Wales and Northern Ireland. By virtue of the Abolition of Feudal Tenure etc (Scotland) Act 2000, from 28 November 2004 it is no longer possible to create what are known in Scots Law as feudal real burdens, ie burdens created by virtue of a feudal superiority which were abolished by the 2000 Act. However, many such burdens were converted into ordinary (non-feudal) burdens on the appointed day, 28 November 2004. Ordinary (non-feudal) real burdens were not extinguished by the Act and it is still possible to create such burdens but they must be praedial in nature (ie relate to land). Restrictions on commercial use of property by one party on another are generally invalid. Moreover, a real burden must not be contrary to public policy, for example, such as to operate in restraint of trade.

leases.) Typically a restrictive covenant runs with the land (ie future owners of that land are also bound by the terms of the restrictive covenant).

7.89 Restrictive covenants may be used to limit the extent to which grocery retailing may be carried out on land that is subject to such a covenant. The precise nature of any restriction may vary. In some cases a restriction may explicitly prohibit or, alternatively, limit grocery retailing in some way (eg by reference to specific retailers or by size of store). In other cases restrictions may be expressed as a positive obligation (eg a site sold to a restaurant chain must be used as a restaurant), which by their effect also prevent the use of land for grocery retailing. The nature of any restriction may be time limited or indefinite.

7.90 Restrictive agreements may also be imposed by local authorities as part of development agreements with grocery retailers. These are not restrictive covenants in the sense that they are not imposed by grocery retailers on the sale of land. We assess these restrictive agreements along with restrictive covenants, however, because in these cases, the local authority may have agreed with a grocery retailer not to allow other land owned by it or sold by it to be used for grocery retailing. The effect of these agreements is therefore similar to a restrictive covenant. In some cases, such agreements may apply to land which is some distance from the land occupied by the grocery retailer that has reached this agreement with the local authority.[1]

7.91 Where a restrictive covenant prevents or restricts use of land for grocery retailing, this has the potential to act as a barrier to entry and allow the grocery retailer that has imposed the restrictive covenant to benefit from weaker competition in that area. Not all restrictive covenants will necessarily act as a barrier to entry. In some cases, a landsite would not have been suitable for grocery retailing even in the absence of the covenant. However, we identified only a few such cases.[2] In assessing whether a restrictive covenant acts as a barrier to entry, we took into account its duration and the possibility of individual landsites on which there is a restrictive covenant being combined with other sites to establish a site suitable for grocery retailing.

7.92 Grocery retailers told us that restrictive covenants may be used for a variety of purposes, such as the protection of non-grocery occupants of the land (eg block of flats above a store), the protection of a grocery store's facilities (eg car parks), and the protection of any uplift in value should planning prospects or the purchaser's use of the property change.[3] We were also told of restrictive covenants said to mirror restrictions agreed to by the grocery retailer in section 106 agreements with local authorities (see paragraph 7.53).

7.93 We accept that there may be various reasons for putting in place a restrictive covenant. However, our primary concern is to identify where the effect of a restrictive covenant has been to establish a barrier to entry enabling a grocery retailer with a strong position in a local market to protect that position, regardless of its underlying purpose.

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[1]For example, such a situation arose in relation to a store relocation by [✂] in [✂].

[2]We found 14 instances out of 73 restrictive covenants where a landsite had a restrictive covenant but where we did not consider the landsite to be suitable for grocery retailing. We did not go on to establish whether these landsites were in highly-concentrated local markets.

[3]We note, however, that there are alternative means of securing a benefit from any future uplift in value through agreements between the parties to a land transaction.

Exclusivity arrangements

7.94 Under an exclusivity arrangement, a landowner (or developer) grants exclusivity to a grocery retailer and agrees not to allow another grocery retailer to operate from site(s) owned by the landowner. Exclusivity arrangements commonly arise in connection with the development of a retail park or shopping centre. The offer of exclusivity can be used to attract a grocery retailer to the development as a so-called 'anchor tenant'. We were told that once a grocery retailer had agreed to open a store within a development, other tenants followed more readily and thus a commitment from a grocery retailer facilitated the letting of other units.

7.95 In some cases the restrictions arising from an exclusivity arrangement may result in an outright ban on all grocery retailing within the shopping centre or retail park other than that carried out by the grocery retailer that is acting as anchor tenant, while in other cases the restriction is targeted at grocery stores of a particular size or at specifically-named grocery retailers. Exclusivity arrangements may be unlimited in duration or last for a specified period.

7.96 Exclusivity arrangements may also be entered into by local authorities in their capacity as landowners in circumstances in which, for example, the local authority has agreed not to allow other land owned by it to be used by other grocery retailers.[1] In a number of these cases the land benefiting from the exclusivity arrangement is not adjacent to the land occupied by the grocery retailer that has reached this agreement with the local authority.

7.97 As with restrictive covenants, we accept that there may be various reasons for putting in place an exclusivity arrangement. However, our primary concern has been to identify where the effect of such an arrangement has been to establish a barrier to entry regardless of its underlying purpose.

Controlled landsites in highly-concentrated local markets

7.98 In the following paragraphs we set out the means by which we identified stores and controlled landsites in highly-concentrated local markets, and our analysis of whether the controlled landsites that we identified in highly-concentrated local markets are barriers to entry in those markets.

Identification of stores and controlled landsites in highly-concentrated local markets

7.99 To identify stores in highly-concentrated local markets, in both the larger-grocery-stores product market and the mid-sized-and-larger-grocery-stores product market, which might have controlled landsites that are a barrier to entry, we looked at:

- monopoly and duopoly stores within a 15-minute drive-time;
- stores where the retailer had a share of floorspace greater than 40 per cent within a 15-minute drive-time; and
- stores where a retailer had a share of floorspace greater than 40 per cent within a 10-minute drive-time.

[1]For example, [✂].

7.100 These measures are consistent with those used to generate our estimate of local market concentration across the UK (see paragraphs 6.8 to 6.13). In that analysis we used various measures of concentration including a 40 per cent and 60 per cent market share threshold (see Appendix 6.1). For this analysis we have used a 40 per cent threshold rather than a 60 per cent threshold (see paragraph 6.9) so that we could be sure of identifying all stores with potentially problematic controlled landsites that might be acting as a barrier to entry. We then carried out a more detailed second-stage analysis on these landsites.

7.101 Using these three measures,[1] we identified a total of 384 grocery stores (331 larger stores and 53 mid-sized stores) in highly-concentrated local markets associated with 368 controlled landsites (324 associated with larger stores and 44 with mid-sized stores) within a 10- or 15-minute drive-time of the store. Store and controlled landsite numbers for Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose under each of these three measures are set out in Table 7.5.

Analysis of controlled landsites in highly-concentrated local markets

7.102 The second step in our analysis was to examine individually each of the 368 controlled landsites identified during the first step to assess whether it represented a barrier to entry.

TABLE 7.5 **Stores and controlled landsites in highly-concentrated local markets with a controlled landsite, eight largest grocery retailers**

	Larger stores (net sales area larger than 1,400 sq metres)		*Mid-sized and larger stores (net sales area larger than 280 sq metres)*		
	No of stores	*No of stores with controlled landsites*	*No of stores*	*No of stores with controlled landsites*	*Unique controlled landsites*
Asda					
Morrisons					
Sainsbury's					
Tesco			✂		
Waitrose					
Somerfield					
CGL					
M&S					
Total	1,208	331	1,564	384	368

Source: CC.

Notes:
1. Controlled landsites associated with stores operated by CGL, M&S, Somerfield and Waitrose were identified by postcode sector as location data was not sufficient for mapping purposes.
2. Sainsbury's has a number of controlled landsites that are associated with more than one store, hence the number of unique controlled landsites is smaller than the number of stores with an associated landsite.

[1]In fact, for the purposes of identifying controlled landsites in highly-concentrated local markets we applied each measure to the product market for larger grocery stores. For larger stores of the mid-sized-and-larger-store product market we applied each measure. For mid-sized stores of the mid-sized-and-larger-stores product market belonging to Tesco, Sainsbury's, Asda and Morrisons stores we applied stores (fascia) with more than 40 per cent of floorspace within a 10-minute drive-time. For mid-sized stores of the mid-sized-and-larger product market belonging to any other fascia, we used monopoly and duopoly stores within a 15-minute drive-time.

7.103 We excluded 171 controlled landsites on the basis that they did not act as a barrier to entry.[1] For the remaining 197 controlled landsites, we conducted a four-stage analytical process to define the local market, assess the degree of local market concentration, examine local factors affecting the degree of intra-market rivalry and assess the likelihood of new entry.

Market definition

7.104 For each of the 197 landsites, we defined the relevant market around the store (or stores) owned by that grocery retailer near to the landsite (the 'associated store(s)'). By identifying those stores that are in the same market as the associated store(s), we were then able to analyse the effectiveness of competition in that market, and the extent to which the controlled landsite represents a barrier to entry into that market.[2]

7.105 We set out in Section 4 our findings regarding market definition for grocery retailing in the UK. These definitions apply across grocery stores in the UK as a whole, but the precise definition of the product and geographic market in each location will vary according to local factors (see paragraphs 4.135 to 4.146).

7.106 We took these factors into account in defining the relevant market for the purposes of analysing the significance of each controlled landsite as a barrier to entry.[3] In each case, our starting point was to define the relevant market for each store associated with a controlled landsite in question (each such associated store being the 'centre store'). We then reviewed the population distribution both between the centre store and those stores within a 10-minute drive-time as well as those stores beyond a 10-minute drive-time, by reference to maps of the area (see Appendix 7.3).[4] We included in the relevant market direct competitor stores more than 10 minutes away where the area between the two stores was densely populated.[5] In some cases we included stores smaller than 1,400 sq metres if we judged them to be sufficiently close in size, to exercise a competitive constraint on other stores in the market.[6] In all

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[1]This included: 8 sites that were already being operated as grocery stores by other retailers; 51 sites that had been or will be used as convenience stores; 6 sites that were used by the retailer for a non-grocery purpose (eg depot); 4 sites for which the use was enforced by a third party (eg leisure centre); 10 sites that were used for extensions to existing stores; 13 sites that were used as houses, flats or offices; 8 sites that were leftover strips of land from previous sales with no potential ransom value; 16 sites that had restrictions or leases that no longer applied, or would shortly cease to apply; 25 sites that had been sold; 8 sites that were in process of sale; 6 other sites, including a restriction on the air-rights above a store; and 16 sites that had been selected on the basis of location errors in the data originally provided by the parties (for example, reversed grid references or incorrect postcodes).

[2]In this analysis we defined the relevant market around each of the stores associated with a controlled landsite. The starting point can affect the outcome of a market definition exercise, and this is particularly the case for the geographic market for grocery stores. The stores included in any given geographic market will depend on size, fascia and location of the store that is the starting point, and there will be a degree of overlap between the geographic markets surrounding each store.

[3]In assessing whether a store should be included in the relevant market, we made a qualitative assessment in each case, based on factors such as population distribution and store configuration, as to whether a small but significant price increase at the stores in the market would lead to an insufficient volume of consumer switching such that a price increase for a hypothetical monopolist of these stores would be profitable.

[4]For the purposes of this assessment, we analysed population density by reference to the number of households per sq km within a postcode sector. In general, we considered that the area between two stores was densely populated where there were more than 1,000 households per sq km within a postcode sector, and sparsely populated where there were fewer than 86 households per sq km within a postcode sector.

[5]In these cases, there is likely to be a large overlap in the potential customers for the stores. Examples of such markets include the market around the Morrisons store on Foundry Street, Dukinfield, Greater Manchester; the market around the Tesco store in Hurst Park, Surrey; and the market around the Asda Monk's Cross store in Jockey Lane, York. In keeping with this, we have also considered that all stores located immediately around the same population centre are in the same relevant market. Examples of such markets include Inverness and Cambridge. We also considered whether stores located less than 10 minutes away from the centre store should be excluded from the relevant market due to there being a sparse population between the stores, indicating an insufficient overlap in the potential customers for the stores to consider them as being in the same relevant market. In practice, only one relevant market was affected in this manner: that was the Asda store in Brynmawr, Blaenau, Gwent.

[6]Examples of this include a [✂] store in Selby, North Yorkshire, with a net sales area of just under 1,400 sq metres and which we consider to be an effective competitor to the slightly larger Somerfield in the town. In general, a store was of sufficiently close size to constrain the centre store in the market if it was about three-quarters of the size of the centre store.

cases, decisions on the stores to be included in the market took into account local features such as store configuration and topography.

7.107 In 34 cases we found that the controlled landsite was not in the same market as the associated store. We excluded these landsites from any further analysis since they could not be acting as a barrier to entry into those local markets.

Assessment of local concentration

7.108 We next assessed the degree of concentration in each local market. We started by assuming a market to be highly concentrated where it had three or fewer fascias in the relevant product and geographic market (in total), and the retailer that owned the landsite had more than a 60 per cent market share. However, as set out in paragraph 6.13 and discussed further below, an individual local market may also be highly concentrated when one fascia has a share of less than 60 per cent, eg this may be the case when a retailer faces very few competitors, such as when the local market is a duopoly.

Local factors affecting the degree of intra-market rivalry

7.109 When products included in the market are differentiated, market share may not reflect the degree of intra-market rivalry. This is a particular concern in retail markets because, by virtue of their location relative to one another and relative to populations, some own-fascia or competitor stores within the relevant geographic market will provide a stronger competitive constraint on the incumbent than others.

7.110 In our detailed site-by-site assessment, we sought to identify stores where the incumbent has a strong local position that is worth protecting. We took into account the location of stores within the relevant geographic market and their position relative to one another.[1] We also noted the location of population centres relative to the store in question. For example, we noted a number of markets that were not particularly highly concentrated, but where the retailer in question had a number of stores in a 'corner' of a town that did not face many competitors and which together gave the retailer a strong local position that was worth protecting.[2] A number of stores associated with controlled landsites did not meet our criteria for assuming that a market was highly concentrated (see paragraph 7.108), but based on our assessment were found to be in highly-concentrated local markets (see Appendix 7.3).

7.111 We found that there were 119 stores associated with 113 controlled landsites in local markets where the incumbent had a strong local position that was worth protecting. We then analysed these local markets further.

New entry

7.112 Next, we analysed the likelihood of new entry occurring in the near future by assessing existing landsites in the relevant market. We reviewed the retailer's declared intentions for the controlled landsite based on evidence provided by the relevant retailer; the size of the landsite; and the status of any planning application

[1]This is consistent with the outcomes of our store profit margin analysis, which suggests that the location of the competing stores has an impact on store profit margin. The further away the competitors are, the higher the profit margin of the centre store (see Appendix 4.4).
[2]In general, we assessed competition in a 'corner' of a town when the retailer in question had more than one store in the area but there were no direct competitors within the same area. For example, this was one factor in our assessment of Asda's position in Boston, Lincolnshire (see maps in Appendix 7.2).

associated with the site. In 14 cases, we identified sites where planning had been granted, and where the new development would mean that the market would no longer be concentrated.[1] On a further nine controlled landsites, stores had already opened by the time we conducted our analysis, or were due to open very shortly. As a result, these were excluded from our analysis of controlled landsites (but were included in our analysis of whether remedies were needed to address multiple stores in highly-concentrated local markets—see paragraphs 11.256 to 11.268).[2]

7.113 As a result of this assessment, we found that 90 controlled landsites act as a barrier to entry in highly-concentrated local markets and have an AEC. Details of our analysis in relation to each individual local market are set out in Appendix 7.3. In summary, of the 90 controlled landsites that are acting as a barrier to entry: 18 are land bank sites, 30 are restrictive covenants, 30 are exclusivity arrangements and 12 are land that has been leased or sub-leased to third parties.[3]

Conclusion on barriers to entry and expansion

7.114 We conclude that barriers to entry or expansion constrain competition by impeding the emergence of competitors able to challenge the offer of existing grocery retailers. We examined three possible barriers to entry or expansion: first, cost advantages for large grocery retailers in general and Tesco in particular; second, the planning regime as it applies to grocery retailing; and finally, the control of land by large grocery retailers.

7.115 We found that large grocery retailers' purchasing cost advantages were likely to be of much greater significance than their distribution cost advantages since purchasing costs make up a substantial proportion of grocery retailers' total cost base. Tesco has a significant advantage in purchasing terms over other large grocery retailers and wholesalers. Asda, Morrisons and Sainsbury's also have a purchasing terms advantage relative to other large grocery retailers and wholesalers, but to a lesser extent than Tesco. Small wholesalers have the highest purchasing costs.

7.116 Customers of small wholesalers could, in many cases, address at least some of their purchasing cost disadvantage by shifting to a larger wholesaler. Further, small wholesalers have the potential to address at least some of their cost disadvantage relative to other wholesalers and grocery retailers by joining a larger buying group. We conclude that convenience stores do not face a barrier to entry arising from any cost disadvantage relative to other grocery retailers.

7.117 We conclude that the presence of the grocery wholesaling sector also mitigates to some extent cost disadvantages for regional grocery retailers and new entrants. We

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[1]In markets where we did not identify landsites held by competing retailers, we believe that entry is unlikely in the near future given the time it takes to acquire and assemble suitable sites for the development of larger grocery stores in particular. This would be the case even where the LPA had identified need for additional grocery retailing in its Local Development Plan. In this latter case there might be some prospect of future entry in the medium term, subject to the availability of suitable sites. For the foreseeable future, however, the local area will remain highly concentrated.

[2]Tesco submitted that in a number of cases entry had been observed in the past and that this illustrated the lack of barriers to entry in these areas. However, our analysis of entry is forward looking as we are assessing whether concentration is likely to persist in the future. Tesco also submitted details of entry by LADs into concentrated markets, and Tesco told us that the discounters' expansion and improved offer in recent years had contributed significantly to competition in the sector. We note that such events do not affect concentration in the relevant market since LADs are not included in the product market. Tesco submitted that these events illustrated that entry opportunities existed. We consider that the demand from non-grocery retailers and LADs for a scarce supply of desirable landsites may have the effect of further frustrating the prospects of entry by an effective competitor. In any case, Tesco told us that it thought that no LAD store exceeded 1,400 sq metres in groceries floorspace, 16 LAD stores exceeded 1,000 sq metres, 200 LADs stores may be just short of a 1,000 sq metre threshold, and that 46 LAD stores exceeded 900 sq metres. As such, these stores will in almost every case be too small to be considered a part of the larger grocery store market regardless of the identity of the operator.

[3]In Appendix 7.3 we summarize the parties' views on the individual controlled landsites, which in our view give rise to an AEC.

recognized that Tesco had a purchasing cost advantage over other grocery retailers. However, we did not find that this currently represents an insurmountable barrier to entry or expansion by other large grocery retailers. We continue to observe the expansion of these other large grocery retailers, and our analysis shows that, subject to some year-on-year variation, Tesco's advantage in purchasing terms has not grown since 2003 despite its increase in total sales and market share. As a result, we do not find Tesco's purchasing cost advantage to have an AEC.

7.118 We found that the planning system, in pursuing the broad-based objectives for which it is intended, necessarily constrains entry by new larger grocery stores. It also increases the time for new larger grocery store entry to take place because of the need to assemble sites likely to be granted planning permission and the time required by LPAs to consider planning applications. The costs associated with site assembly and submitting a planning application, and the risk of planning permission not being granted, mean that the existing large grocery retailers with substantial experience of the planning system are in a better position to mitigate or absorb these costs and risks than other grocery retailers and new entrants.

7.119 We found that the planning regime places more limited constraints on the extension of existing larger grocery stores compared with entry of new larger grocery stores. An incumbent grocery retailer, by extending its store, makes it more difficult for a new larger grocery store entrant to come into the market.

7.120 We also found that the planning regime places limited constraints on entry or expansion by mid-sized grocery stores and convenience stores, since it is easier for such stores to find suitable locations that are not subject to planning restrictions.

7.121 The shortage of land available for new larger grocery stores, arising in part from the planning system, means that the control of this land by grocery retailers in certain highly-concentrated local markets frustrates new entry that would strengthen competition. We did not find that grocery retailers were engaging in holding undeveloped land (landbanking) as a strategy to impede the entry by rival grocery retailers into local markets. However, we found that 90 controlled landsites act as a barrier to entry in highly-concentrated local markets and have an AEC. These included 18 land bank sites, 30 restrictive covenants, 30 exclusivity arrangements, and 12 landsites that are leased or sub-leased to third parties.

7.122 In summary, in terms of the three major product markets that we identified, we conclude that:

- for larger grocery stores, an AEC arises from the planning system, which constrains overall entry and also acts in favour of the existing large grocery retailers, and controlled landsites, which act as a barrier to entry in a number of highly-concentrated local markets;
- for mid-sized and larger grocery stores, an AEC arises from controlled landsites, which act as a barrier to entry in a number of highly-concentrated local markets; and
- for all grocery stores, limited barriers to entry or expansion mean that we have not identified an AEC.

8. Coordination between grocery retailers

8.1 This section considers coordination between grocery retailers in the supply of groceries. Competition law draws a distinction between explicit coordination (which we refer to in this section as 'collusion'[1] and which includes cartel activity), where parties agree to fix prices, production levels or share markets, or engage in a concerted practice with a similar effect, and tacit coordination, where competitors recognize their mutual interdependence and, as a result, compete less vigorously without explicitly communicating, either directly or through third parties, their intention to do so.[2]

8.2 The structure of UK competition enforcement involves a division of functions between the CC and the OFT in relation to coordination. The OFT is responsible for enforcing the provisions of the Competition Act 1998 and Article 81 of the EC Treaty in relation to collusion,[3] while the CC investigates tacit coordination, where relevant, in the context of merger inquiries and market investigations that are referred to it.[4] To the extent that a market investigation or merger inquiry reveals any specific evidence of collusion, we will pass that evidence to the OFT for further investigation, and will respond appropriately to any requests from the OFT for information in our possession.

8.3 The section is set out as follows:

- First, we review recent actions by the OFT in the investigation of alleged cartels involving grocery retailers and discuss facets of grocery retailing that may facilitate collusion.

- Second, we examine the conditions under which tacit coordination is most likely to be sustainable and whether these conditions are present in UK grocery retailing.

Collusion

8.4 Collusion is prohibited under Chapter I of the Competition Act 1998 and Article 81 of the EC Treaty. The OFT has recently taken a number of steps to investigate collusion among grocery retailers.

8.5 In September 2007, the OFT announced that it had issued a provisional decision or 'statement of objections' to five grocery retailers (Asda, Morrisons, Safeway, Sainsbury's and Tesco) and five dairy processors (Arla Foods UK plc (Arla), Dairy Crest Group plc (Dairy Crest), Lactalis McLelland Ltd, The Cheese Company and Robert Wiseman Dairies plc (Wiseman)). The specific allegations are detailed in the OFT's press notice of 7 December 2007.[5]

8.6 The OFT's statement of objections alleged that these grocery retailers and dairy processors variously shared highly commercially-sensitive information in respect of the retail price of certain dairy products in 2002 and/or 2003.[6] This commercially-sensitive information was disclosed indirectly between grocery retailers, with processors acting as the intermediaries through which information was disclosed.

[1]Economists define collusion as a market outcome and will often use the term 'collusion' to refer to both explicit and tacit coordination. It is important to note that, in this section, we use the term only to refer to explicit coordination.
[2]*Market Investigation References: Competition Commission Guidelines, CC3*, June 2003, paragraphs 3.56 to 3.73, sets out a description of the factors that the CC will take into account in assessing the likelihood of tacit coordination arising in a market. Tacit coordination does not require that any parallelism of prices between firms is 'conscious' in the form of an explicit or documented analysis of interdependent price strategies. Instead, the behaviour can arise purely from firms' perception of interdependence, with the benefits of such behaviour accruing to all firms in the market.
[3]The sectoral regulators exercise similar functions within their respective fields.
[4]In certain circumstances, the OFT may review tacit coordination under Chapter II of the Competition Act 1998 and Article 82 of the EC Treaty, in the context of collective dominance.
[5]See www.oft.gov.uk/news/press/2007/170-07.
[6]The OFT will make a final decision on whether or not competition law has been breached once it has received and reviewed the parties' responses to the statement of objections, any comments from interested third parties and a further assessment of all of the relevant evidence.

8.7 Since the announcement of its statement of objections, the OFT has concluded early resolution agreements with Asda, Dairy Crest, Lactalis McLelland Safeway (in relation to conduct prior to its acquisition by Morrisons), Sainsbury's, The Cheese Company and Wiseman, resulting in admissions of involvements and agreement to pay more than £120 million in penalties, before any discounts for cooperation.[1] The OFT is continuing its case against Morrisons and Tesco and these proceedings are ongoing.[2]

8.8 Further, in April 2008, shortly before the publication of this report, the OFT issued a statement of objections concerning alleged anti-competitive retail price practices and, for certain parties, indirect exchange of future price information regarding the supply of tobacco products. This case involves a number of tobacco product manufacturers and retailers, including grocery retailers.[3]

8.9 We looked at structural aspects of the market as well as the conduct of grocery retailers and their suppliers that might prevent, restrict or distort competition by facilitating collusion. This included the type of conduct that the OFT has alleged took place in its investigation into dairy products as well as the extent of concentration in the groceries supply chain and the use of category management practices by grocery retailers.

Concentration in the groceries supply chain

8.10 Increased concentration in the groceries supply chain may make collusion more likely. The exchange of information between retailers via their suppliers is simpler when there are fewer suppliers of a particular product or category. We note that the alleged conduct identified by the OFT in its statement of objections to grocery retailers and the processors of dairy products occurred against a background of consolidation in the dairy products sector in recent years (see paragraph 3.35).

8.11 We identified a trend of consolidation among upstream intermediaries in other sectors, particularly in fresh produce. There is, for example, a move towards consolidation of intermediaries in the supply of fruit to retailers. Along with the benefits of scale, intermediaries in the fruit sector are seeking to offer year-round availability of fruit to retailers, and accordingly have sought to merge with other intermediaries which source from other countries. The four largest marketing agents in the UK currently supply 80 per cent of UK-produced fruit sold to large grocery retailers (see Appendix 9.6). There is also some evidence of consolidation in the abattoir sector. In 2005 there were only six integrated pig-processing companies in the UK (see Appendix 9.5).

8.12 This consolidation has been encouraged by grocery retailers to some extent which have sought to reduce costs by reducing the number of suppliers that are used in each product category (see paragraph 3.37). If this continues, such consolidation may make collusion easier to undertake.

Category management

8.13 Category management is a relatively common practice within grocery retailing that aims to improve a grocery retailer's sales or performance in a particular product

[1]The OFT approach to penalties is set out in its guidance: *OFT's Guidance as to the appropriate amount of a penalty* (OFT 423). Penalties cannot exceed 10 per cent of the worldwide turnover of the undertaking in its last business year.
[2]Arla had previously applied to the OFT for leniency. The OFT has stated that it will receive complete immunity from financial penalty if it continues to cooperate fully.
[3]See OFT press release at www.oft.gov.uk/news/press/2008/56-08.

category through collaboration between that grocery retailer and its suppliers. To this end, a grocery retailer may exchange information with its suppliers on sales volumes and trends, consumer demographics, profiles and preferences, and a retailer may take advice from suppliers on the range of products displayed, placement and size of the product displays, pricing, promotion, supply chain improvements and stock management.

8.14 Category management can introduce efficiencies as a result of suppliers' better knowledge of consumer demand. For example, a supplier is likely to be better positioned from its consumer research to provide advice on the products in a category most likely to appeal to different types of consumers, and can lead to better market information or trading advantages being available to a particular supplier (see Appendix 8.1). This may directly benefit consumers and result in increased total sales in the category. However, extensive use of category management might also bring about an environment which could facilitate collusion between retailers, between suppliers, and collusion involving both retailers and suppliers.

8.15 For example, a supplier providing the same category management advice to a number of retailers may dampen competition between those retailers. Alternatively, category management could give rise to collusion by facilitating an indirect exchange of information between competing retailers through suppliers. Similarly, category management may provide increased opportunities to exchange information between suppliers, whether directly or indirectly via retailers.

8.16 To assess the extent to which category management might facilitate coordinated behaviour, we reviewed category management practices in two product categories—fresh fruit and yogurt—and within one major food conglomerate. Each of these case studies showed varying levels of supplier interaction as a result of category management relationships. In two cases, we saw evidence of retailers approving of interactions, and exchange of category management advice, between suppliers and, in certain instances, retailers encouraging and assisting meetings of suppliers.

8.17 The clearest examples were evident in yogurt. We reviewed emails, provided by a supplier, where [✂] had organized a meeting for all its dairy food category managers, and urged some of its suppliers of competing products to conduct a monthly discussion on category recommendations. The emails that we reviewed also showed that meetings are sometimes encouraged by [✂] in that sector.[1] [✂] also told us that it held an annual strategy day with its yogurt suppliers. During the day it presented headline changes that it intended to implement in the coming year and had a discussion to start the category review process.[2] We also observed coordinated activities between suppliers in the fruit sector. However, it seems likely that these activities are a function of the intermediaries endeavouring to secure consistent levels of supply.[3] We saw no instances where the food manufacturer that we studied was involved in meetings with other suppliers.[4]

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[1]The supplier told us that the supplier forums organized by [✂] and [✂] no longer take place.

[2]We were told that the presentations are a statement of the retailer's plans where suppliers are allowed to ask questions but not allowed general discussion between themselves on category recommendations. The presentation is intended to focus certain suppliers to provide information on areas that the retailer is interested in, and ensure that they receive advice on a full spectrum of issues. For example, at the presentation in November 2006, suppliers were asked to provide advice on the sale of yogurts in different formats of the retailer's stores. However, the advice was provided separately by the suppliers to the retailer in the following months, not on the strategy day itself.

[3]The British Independent Fruit Growers Association expressed concerns about the level of supplier interaction and stated that it affected the profit of independent growers. However, it appears that the intermediaries provide an important security of supply service to the retailers. A degree of interaction between intermediaries seems justified in order to ensure that a retailer is not relying on alternative supply options involving the same ultimate grower.

[4]We saw one example of a joint presentation to a retailer. However, we understand that this 'joint' presentation was a result of Tesco purchasing the One-Stop chain and was therefore an exception to the usual business practice of [✂]. The presentation content was no different from other presentations made by [✂].

8.18 The degree of interaction among suppliers arising from category management is a cause for concern. Given the level of interaction among suppliers, and the large amount of information that is passed between retailers and suppliers, there is an opportunity for competitive harm. Absent collusion downstream, a retailer would have the incentive to prevent collusion between suppliers. Category management might be a means by which collusion of this type is facilitated, but in the three product categories that we reviewed, we did not find evidence of this taking place.

Review of grocery retailer–supplier communications

8.19 Our review of emails between buyers at Tesco and Asda and their suppliers for the five-week period between 18 June 2007 and 22 July 2007 provided some instances of suppliers providing information to retailers in relation to rival retailers (see Appendix 9.1). The review consistently showed suppliers providing information to retailers on the current retail price at which competitors were selling goods, as well as details of current product promotions at competitors. There were also some examples where suppliers offered information to grocery retailers regarding the future plans of competitors. Our review did not, however, involve a search for evidence of any of these offers being accepted by grocery retailers. However, in some cases, the emails we reviewed showed an explicit rejection of an offer of information being made by a supplier.

Tacit coordination

8.20 Where markets are sufficiently concentrated, the actions of individual firms can have identifiable effects on their competitors, such that firms recognize their interdependence and assess their own conduct accordingly. If this interdependence persists over time, the repeated nature of the interactions between firms can have significant effects on business strategies and on competition. In particular, firms may refrain from initiating price cuts that would occur in more competitive circumstances. This type of behaviour is referred to as tacit coordination. It does not require any type of collusion (ie agreement or concerted practice) between firms or even any contact between them. Nevertheless, such behaviour is capable of weakening competitive pressures and harming competition and can therefore form the basis of an AEC finding.

Conditions necessary for tacit coordination

8.21 Our guidelines set out three conditions that are necessary for tacit coordination to exist and to be sustainable over time.[1] First, the market has to be sufficiently concentrated for firms to be aware of the behaviour of their competitors, and any significant deviation from the coordinated behaviour by one of the coordinating firms must be readily apparent to other firms.

8.22 A coordinated strategy, however, is not always sustainable, as individual firms have an incentive to undercut competitors so as to increase sales and earn additional profits. As a result, the second condition for tacit coordination to be sustainable is that competitors are able to take retaliatory action that punishes any firm that deviates from coordinated behaviour. Finally, for tacit coordination to be successful, other competitive constraints in the market must be relatively weak, so that the

[1] *Market Investigation References: Competition Commission Guidelines, CC3*, June 2003, paragraphs 3.62 to 3.64.

actions of non-coordinating firms, potential competitors and customers do not disrupt coordinated behaviour.[1]

8.23 In the following paragraphs, we consider the extent to which each of these conditions is met in UK grocery retailing, particularly in relation to large grocery retailers.

Market concentration and monitoring deviations

8.24 Grocery retailing, in terms of national sales shares in the UK, is relatively highly concentrated. As we set out in paragraph 3.4, the four largest grocery retailers have just over 65 per cent of national grocery sales. These four grocery retailers and four others (CGL, M&S, Somerfield, Waitrose) account for 90 to 95 per cent of all larger grocery stores in the UK (see paragraph 3.7), and nearly 90 per cent of all mid-sized and larger grocery stores in the UK (see paragraph 3.9).[2]

8.25 There is also a considerable degree of price transparency in the sector given the uniform national pricing strategies of the four largest grocery retailers and other grocery retailers (see paragraphs 4.98 to 4.101), and the publication of data showing current prices for thousands of items at each of the four largest grocery retailers (eg Tesco price check).[3] Grocery retailers monitor the prices of many of each other's products (see paragraphs 4.66 to 4.67). However, grocery retailers sell a large number of products, and there may be a lack of comparability between certain own-label products although we note that in certain cases the same manufacturer may supply own-label products for a number of grocery retailers.[4] It is far easier to coordinate on a price for a single, homogenous product than on thousands of prices in a market with many differentiated products.[5] It is easier to coordinate on the prices of a smaller group of products. Accordingly, because grocery retailers sell thousands of products, for a coordinated strategy to emerge, they would have to recognize their interdependence on a select group of products. Without exchanging any information, it would be difficult for retailers to actually select the category of products on which they would coordinate.

8.26 There are a number of other factors that may assist grocery retailers in undertaking the monitoring required for tacit coordination to succeed. In particular, the relatively stable environment of the grocery sector facilitates monitoring of rivals' behaviour.[6] All the large grocery retailers have long-term financial commitments to the sector. As

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[1]Low barriers to entry, a strong competitive fringe of firms and countervailing buyer power might all serve to disrupt coordinated behaviour.
[2]The fact that many of these parties (particularly the four largest grocery retailers) meet in a large number of local markets will increase the likelihood that coordination emerges. Indeed, although they may have different local market positions, the fact that they may be strong in some markets and weak in others makes them less likely to engage in aggressive price reductions in local markets where they would gain, fearing retaliation in other markets. This is not to say that retaliation would necessarily have to occur in individual local markets. As discussed in paragraph 8.30, retaliation could involve aggressive price reductions at all stores. The retailer that has deviated from the coordinated outcome will lose customers at those stores that face rivals that respond with aggressive price reductions. Therefore, the punishment would have greater effect where they meet more often in local markets.
[3]In the event that localized pricing was employed by more grocery retailers, tacit coordination would require coordinated pricing across different local markets as well as many different products.
[4]As set out in paragraph 8.1, we distinguish collusion from tacit coordination. We consider that without any exchange of information it would be particularly difficult for a collusive strategy to emerge on a wide range of differentiated products. Grocery retailers would need to recognize focal points for coordination among the thousands of products that they sell, many of which are differentiated. With new products being launched each year, this would further complicate any coordinated strategy.
[5]A coordination strategy that might potentially be easier to implement would be to focus coordination on a subset of products, such as a basket of the most popular products (eg known-value items). However, for tacit coordination to be successful, the exact composition of the basket of products that was subject to coordinated action would need to be clear to each of the parties involved. Tacit coordination between grocery retailers on the prices of a small group of products, particularly uniform or commodity products, is an alternative strategy that would address the complexities and uncertainties of more broad-based coordination.
[6]If the market situation is unstable or changeable, it is more difficult for firms to determine whether a price adjustment reflects the new situation, or is instead partly a deviation from the coordination strategy.

a result, competitors expect that their major rivals will be present in the future, further stabilizing the competitive environment. Further, demand for groceries, as a necessary purchase for consumers, is fairly stable, without any major fluctuations. Grocery revenues have been increasing in real terms by approximately 3 per cent a year. Furthermore, there is no evidence of major and frequent supply shocks that can have a significant impact on an industry.

8.27 Similarities between the business models for grocery retailers may also facilitate tacit coordination. Changes in production costs affect all retailers equally. Grocery retailers will therefore be better able to distinguish aggressive price cuts from price changes that reflect shocks in production costs.

Punishment mechanism

8.28 Large grocery retailers can reduce prices quickly and by amounts sufficient to impose a significant cost on a rival deviating from coordinated behaviour. The deviating retailer then runs the risk of a significant loss as customers start shopping elsewhere.

8.29 Punishment may be more effective where coordination is based on a smaller group of products. If a grocery retailer were to deviate from a coordinated strategy on a small number of commodity products, it would stand to gain relatively little compared with the significant losses that would be incurred if rivals responded with price cuts on a very large number of products. As the price cuts would take place on many products, the deviating firm's profit losses could easily outweigh the gains on a narrow set of products.

8.30 The threat of retaliation is only credible if there is sufficient certainty that, on detecting deviation, rivals will activate the punishment mechanism. Grocery 'price wars' on a large portfolio of products might indicate periods of punishment for deviation from the coordinated strategy, or serve as a reminder that retaliation is not merely hypothetical. For example, on 15 June 2007, both Tesco and Asda announced price cuts across their product ranges. Asda said that it was cutting 10,000 prices across groceries and non-grocery products at a cost of £250 million. On the same day, Tesco announced that it would be cutting prices on 3,000 products at a cost of £270 million.[1] While this may be an example of aggressive competition, it is also consistent with a punishment mechanism. The widespread price reductions provide some evidence that punishment is thus a credible threat that might make a narrow-based coordination strategy sustainable.

Outside constraints

8.31 Barriers to entry for new larger grocery stores, which are predominantly operated by large grocery retailers, are significant (see paragraph 7.122), so we do not believe that high prices and profits would attract new retailers to enter on a scale sufficient to disrupt a coordinated strategy.

8.32 A strong competitive fringe might disrupt coordinated behaviour if those firms do not have an incentive to coordinate with the main market participants. There are several competitors in UK grocery retailing who, if they do not adhere to coordinated conduct, could destabilize a coordinated strategy. It is possible that firms which operate mid-sized grocery stores and smaller numbers of larger grocery stores and are present in a number of local markets, may be able to undercut coordination by the four largest

[1]Both Tesco and Asda stated that these price reductions were motivated by tighter household budgets and a desire to assist households in cutting their weekly shopping costs.

grocery retailers, although it is also possible that these retailers might themselves engage in tacit coordination with the large retailers.

Conclusion on conditions

8.33 Our review of the conditions necessary for tacit coordination to arise and be sustainable suggested that these conditions may be present in UK grocery retailing. However, we consider that the complexity of sustaining coordinated conduct over thousands of differentiated products made it more likely that tacit coordination would arise for a smaller group of products. However, for this latter coordinated strategy to emerge, grocery retailers would have to overcome the difficulty of selecting a group of products without exchanging information.

Evidence of tacit coordination

8.34 The existence of the three conditions discussed in paragraphs 8.21 to 8.23 is necessary for tacit coordination to arise, but, to be confident in a finding that tacit coordination was taking place, we would also expect to be able to find some evidence of coordination.[1]

8.35 In grocery retailing, we believe that a coordinated strategy on prices is most likely. It seems unlikely that retailers would coordinate tacitly to limit production or the amount of new capacity brought to the market. We have seen retailers building new stores, expanding their capacity at various rates and over the past few years, Sainsbury's and Tesco have acquired numerous convenience stores. Firms may also coordinate tacitly by sharing the market, for instance by geographic area, although we have not observed conduct which would be consistent with such a strategy. We have not seen, for example, retailers refraining from expanding in regions where they are relatively under-represented. We therefore looked at whether grocery retailers might be coordinating on price. If tacit coordination were occurring, we would expect to observe parallel movements in prices (although acknowledging that parallel pricing can also be evidence of strong competition).

8.36 In paragraph 8.33, we identified the potential difficulties faced by grocery retailers seeking to coordinate the prices of a large number of grocery products or even on a smaller group of products. In addition, price trends that we reviewed do not, in themselves, appear to provide evidence of price coordination. The evidence indicates that, until recently, food prices have been falling in real terms (see paragraphs 3.40 and 3.41), but importantly, prices also change frequently relative to the Retail Price Index.[2] While not conclusive, the persistent fall in real prices of groceries may indicate the absence of tacit coordination. However, it does not enable us to identify whether reductions in the retail price fully reflect reductions in costs.[3]

8.37 We note that some observers have expressed concerns over the apparent convergence of prices of the four largest grocery retailers in recent years, though this is

[1]A market investigation is different from a merger inquiry in that in a merger inquiry we are concerned with whether the merger makes tacit coordination more likely.

[2]If grocery retailers are coordinating across many products, we might expect to see this reflected in food prices. For example, we might expect to see little variation in (real) food prices.

[3]As discussed above, the OFT is currently investigating alleged collusion involving a number of large grocery retailers and suppliers in relation to dairy products. There are clearly significant risks for retailers who engage in collusion; not least, the threat of considerable fines under the Competition Act 1998 or Article 81 of the EC Treaty. If the OFT's allegations were to be established, the existence of collusion between retailers might be interpreted as indirect evidence that tacit coordination is difficult to sustain without some way of focusing on particular products, since it is reasonable to assume that retailers would not have taken the risk of engaging in collusion if tacit coordination had been a viable strategy.

not indicated by [✂] price index.[1] Price convergence would be consistent both with increased coordination, but also with increasing retail competition, particularly when competitors become more similar in terms of efficiency.

8.38 The fact that the large grocery retailers have not grown at the same pace over the last few years, and have unequal shares of the supply of groceries, suggests that their individual interests are not fully aligned. In general, smaller competitors have a strong incentive to catch up with the leaders by improving their retail offer and reducing prices, but they would be unable to do this if they were to adhere to a co-ordinated strategy. As a result, adhering to a strategy of higher prices would prevent these retailers from catching up with the leaders. However, we note that cost differences between large grocery retailers and other grocery retailers may alter the incentives to coordinate, particularly given the relationship between size and purchasing costs (see paragraph 7.22). We also note that the effect of the asymmetry of the large grocery retailers on the likelihood of sustainable coordinated conduct may be offset to some extent by the size of their market shares. The large market shares of the major grocery retailers imply that they stand to lose a lot from retaliatory action from competitors. In fact, any such losses would be likely to be higher than the gains from aggressive price cutting.

8.39 While we have not seen evidence of large grocery retailers engaging in parallel behaviour with respect to the prices of a large set of products, we note that prices have become more transparent over the last few years, making it easier for grocery retailers to find relevant focal points (ie establish the terms of coordination) and to monitor deviation.

Findings on coordination

8.40 Our review of the conditions necessary for tacit coordination to arise and be sustainable suggested that these conditions may be present in UK grocery retailing. However, it may be that sustaining coordinated conduct over thousands of differentiated products or choosing a smaller group of products on which to coordinate would be sufficiently complex to prevent the emergence of tacit coordination. Further, we have not seen evidence of large grocery retailers engaging in parallel behaviour with respect to prices. As a result, we did not find that grocery retailers were engaged in tacit coordination. However, we are concerned that, given the structure of the grocery retailing market, such behaviour could occur in the future.

8.41 In relation to collusion, the OFT has responsibility for ensuring that the provisions of the Competition Act 1998 are enforced. We note the OFT's recent actions in this area involving grocery retailers.

9. Competition issues in the groceries supply chain

9.1 A broad range of issues relating to the groceries supply chain was raised during our investigation. These relate primarily either to the behaviour of grocery retailers towards their suppliers (eg prices paid to suppliers, purchasing terms) or to the effect of this behaviour on suppliers (eg supplier profitability and innovation, the number of suppliers). A common theme is the exercise of buyer power[2] by grocery retailers. In this section we examine:

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[1] [✂]
[2] Buyer power is a form of market power that a grocery retailer may have with respect to its suppliers that allows the grocery retailer to extract better terms from its suppliers than would otherwise be the case.

- the concept of buyer power, the circumstances in which the exercise of buyer power by grocery retailers may give rise to an AEC, and the extent to which UK grocery retailers possess buyer power (see paragraphs 9.2 to 9.21);

- the financial performance and structure of the groceries supply chain in the context of potential concerns regarding grocery retailers' buyer power (see paragraphs 9.22 to 9.36); and

- the behaviour of grocery retailers towards their suppliers in terms of supply chain practices, demand withholding and the sale of own-label products (see paragraphs 9.37 to 9.81).

Buyer power and grocery retailers

9.2 Buyer power is a form of market power that a firm—in this case a grocery retailer (or wholesaler or buying group)[1]—is able to exercise in relation to its suppliers.[2] A grocery retailer exercising buyer power would obtain a better deal from its suppliers in terms of prices, product quality or purchasing terms, for example, compared with grocery retailers that do not have buyer power. A supplier is likely to earn a smaller profit margin on goods sold to a grocery retailer with buyer power than those sold to grocery retailers that do not have buyer power.

Buyer power and consumer harm

9.3 The exercise of buyer power by grocery retailers (and wholesalers or buying groups) may have a detrimental effect on suppliers (for example, through diminishing their profitability). However, the exercise of buyer power does not necessarily of itself constitute an AEC. While we do not need to identify specific harm to the interests of customers in order to find an AEC, we will be more confident of an AEC finding where the feature, or combination of features, adversely affects the interests of present or future customers (see Appendix 2.2).[3]

9.4 In general, the exercise of buyer power by grocery retailers is likely to have positive implications for consumers. Where competition between grocery retailers is effective, retailers will pass on to consumers a substantial portion of the lower prices that they obtain from suppliers through the exercise of buyer power. Grocery retailers' buyer power may also act as a countervailing force to any market power possessed by

[1]While wholesalers and buying groups may, in certain circumstances, have buyer power (see paragraphs 9.6 to 9.9), the CC does not have the power to make findings in this investigation, or to take remedial action, including formal recommendations, in relation to the buyer power of wholesalers or buying groups, unless the wholesaler, or the corporate group to which it belongs, owns grocery stores. This is because wholesalers do not participate in the 'reference market' (ie the supply of groceries by retailers in the UK), so any conduct by such wholesalers would not constitute a 'feature' under the Act. Our consideration of remedial action with respect to wholesalers which do own grocery stores is discussed in paragraphs 11.283 to 11.285.

[2]A firm with buyer power may also have market power in relation to its customers, but this will not necessarily always be the case.

[3]We considered whether we needed to identify specific detriment to customers in the reference market (ie final consumers of groceries) arising from the exercise of buyer power in order to find an AEC, or whether it was sufficient to conclude that buyer power distorts competition in connection with the acquisition of groceries by retailers, upstream of the reference market. For the reasons outlined in Appendix 2.2, we concluded that it is not necessary for us to demonstrate that buyer power leads to specific and identifiable detriment to consumers of groceries in order to decide that the exercise of buyer power constitutes an AEC. Nevertheless, as noted in Appendix 2.2, section 134(5) of the Act defines 'detrimental effect on customers' for the purposes of remedial action. We would expect to be able to identify current harm to consumers, or have an expectation that harm to consumers would result in the future, in order to take remedial action.

suppliers. In addition, the exercise of buyer power can spur innovation in the supply chain.[1]

9.5 The exercise of buyer power by grocery retailers may, however, raise concerns in certain limited circumstances if it allows retailers to impose excessive risks and unexpected costs on suppliers, which reduces suppliers' incentive or ability to invest and innovate. This could lead to reduced capacity, reduced product quality and fewer new product offerings, and ultimately, to a detriment to consumers. Therefore, when assessing the behaviour of grocery retailers in relation to suppliers in paragraphs 9.37 to 9.81, we particularly looked at the business (or supply chain) practices of grocery retailers that might transfer excessive risks or unexpected costs on suppliers and thereby reduce supplier investment and innovation, when compared with the levels of investment and innovation that would be observed in a well-functioning market.

Possession of buyer power by UK grocery retailers

9.6 The following paragraphs assess the extent to which particular grocery retailers, wholesalers and buying groups in the UK have buyer power. In doing so, we took into account the following evidence:

- the size of grocery retailers relative to suppliers;
- the prices and margins that suppliers are able to negotiate with grocery retailers;
- the share of the retail price earned by grocery retailers and others in the supply chain for various primary products; and
- our review of email correspondence between Asda and Tesco and their suppliers.

The size of grocery retailers relative to suppliers

9.7 The size of a purchaser (here, a grocery retailer), in terms of both its size relative to the market and relative to the supplier, is a key influence on a grocery retailer's buyer power in relation to a supplier:

- For products where there are numerous suppliers and a single 'market price' is paid by all grocery retailers, a grocery retailer's buyer power is influenced by the size of the grocery retailer's sales relative to total product sales, and the degree of concentration of grocery retailers in relation to sales of the product.
- For products where suppliers are relatively concentrated and prices are negotiated bilaterally between grocery retailers and suppliers, a grocery retailer's buyer power will be determined by the extent of a grocery retailer's reliance on its supplier and vice versa. The extent of this reliance will be influenced by the size of the grocery retailer relative to its supplier, the alternatives that the retailer has for supply, and the alternatives the supplier has for access to final consumers.
- The extent of grocery retailers' vertical integration will also influence their buyer power. The fact that large UK grocery retailers have a vertically-integrated whole-

[1]It has been put to us that it may be incorrect to assume a simple, unidirectional link between retailer bargaining strength and the level of innovation by suppliers. Certain studies find that, in some cases, retailer bargaining strength vis-à-vis suppliers can serve to stimulate innovation and new product development. We have also been provided with an analysis of industry data, which finds a positive relationship between the rate of new product development in different product sectors and the proportion of retail sales, in that sector, that occur through grocery retail chains. See London Economics, *Dynamic Investment and Innovation in the UK Grocery Supply Sector*, February 2007.

saling function means that they control suppliers' access to final consumers. This 'access to market' is an important factor in influencing these retailers' buyer power with respect to suppliers.

- Buyer power will also depend on other factors such as the negotiating skill and organization of a grocery retailer's buying function; whether a grocery retailer serves as a gatekeeper to access certain local markets; the financial viability of suppliers; and the presence of own-label products.

9.8 The four largest grocery retailers account for a significant proportion of total grocery retail sales in the UK, and each of them has significantly larger sales than other grocery retailers within the UK. The share of total retail grocery sales held by each of the large grocery retailers is set out in paragraph 3.4 and Figure 3.1. While this data refers to total grocery sales rather than sales at a product level, there is relatively limited variation between the total sales shares of these four grocery retailers and their sales shares at the product category level.[1] This size relative to other large grocery retailers would tend to suggest that the four largest grocery retailers are likely to possess buyer power in most product categories.

9.9 According to the GfK supplier survey, most grocery suppliers have relatively small sales, with only around 15 per cent of suppliers to UK grocery retailers having a turnover of more than £50 million a year. As a result, large grocery retailers, wholesalers and buying groups are likely to have significantly greater sales than most of their suppliers.

Prices and margins earned by suppliers of groceries

9.10 The prices and margins that suppliers earn in supplying grocery retailers, wholesalers and buying groups can also indicate the presence of buyer power. We reviewed evidence on supplier prices and margins arising from:

- our analysis of supplier prices;
- a comparison of wholesale and retail prices provided by the ACS;
- the GfK supplier survey; and
- qualitative evidence from suppliers on the factors that influence supplier pricing.

CC analysis of supplier prices

9.11 We set out the results of our analysis of supplier prices in paragraphs 5.19 to 5.43. This showed that suppliers receive the lowest prices, on average, from Tesco and obtain the highest prices from small wholesalers and buying groups. It also showed that some large wholesalers and buying groups pay prices to suppliers that are, on average, comparable with large retailers. In addition, our analysis indicates that purchasing price advantages for customers placing large orders is far more prevalent for non-primary branded products than for primary branded products (see Appendix 5.3).

[1] TNS product sales data for 13 UK grocery retailers shows that in only seven product categories does a grocery retailer's sales share for a product outperform or underperform its national sales share for all groceries by more than three percentage points. The most notable exceptions are in chilled ready meals, where M&S has a national sales share of 21.2 per cent compared with a national groceries sales share of 3.3 per cent, and in frozen foods, where Iceland has a national sales share of 11.9 per cent compared with a national groceries sales share of 1.7 per cent.

ACS comparison of wholesaler buying prices and grocery retailer selling prices

9.12 The ACS submitted a comparison of the prices at which wholesalers purchased certain products from suppliers and the retail prices charged by large grocery retailers for those products. The results of this study were broadly consistent with our view that differentials exist between the prices paid to suppliers by many (although not all) wholesalers and the prices paid by the four largest grocery retailers.[1] However, there are a number of reasons why we find the ACS analysis to be of limited use in understanding the extent to which these differentials exist and, for these reasons, we placed limited weight on it (see Appendix 5.3).

GfK supplier survey

9.13 As part of the GfK supplier survey, respondents were asked to identify the type of customer from which they received their highest and lowest margins (see Table 9.1). Suppliers indicated that the lowest margins were most commonly earned on sales to the four largest grocery retailers. However, other customers, including wholesalers, were mentioned by nearly half of all suppliers. Suppliers also reported that the four largest grocery retailers paid the highest margins more frequently than wholesalers or buying groups.

TABLE 9.1 **Customers from whom the lowest and highest gross margins are received**

Customers from whom the lowest gross margins are received	*%*	*Customers from whom the highest gross margins are received*	*%*
Any of four largest grocery retailers	53	Any of four largest grocery retailers	22
Any other grocery retailers	17	Any other grocery retailers	27
Wholesalers/buying groups	8	Wholesalers/buying groups	12
Independent retailer	6	Independent retailer	34

Source: GfK, *Research on suppliers to the grocery market: A Report for the Competition Commission*, pp59–60.

9.14 Suppliers were also asked about their perceived level of bargaining power with grocery retailers and wholesalers. Suppliers generally considered themselves to have a lower level of bargaining power with the four largest grocery retailers compared with other grocery retailers and wholesalers or buying groups (see Table 9.2). However, many suppliers reported that they had minimal levels of bargaining power with other grocery retailers and wholesalers or buying groups.

TABLE 9.2 **Perceived level of bargaining power of suppliers with customers**

Customer type	*9–10 (complete control)*	*7–8*	*5–6*	*3–4*	*1–2 (no control)*	*Mean*
Four largest grocery retailers	3	9	33	34	22	4.18
Other grocery retailers	4	17	40	27	12	4.99
Wholesalers/buying groups	4	24	37	21	13	5.18

Source: GfK, *Research on suppliers to the grocery market: A Report for the Competition Commission*, p40.

9.15 When the data reported in Table 9.2 is broken down by type of supplier, 'small suppliers', 'suppliers of own-label products' and 'suppliers of fresh produce' each

[1]The ACS submitted a comparison between the price paid to suppliers by three grocery wholesalers for 317 SKUs and the retail price for those same SKUs at Asda, Sainsbury's and Tesco. The comparison showed that for 32 items (10 per cent of the total), the average wholesale price was higher than the average retail price charged by Asda, Sainsbury's and Tesco.

reported lower perceived levels of bargaining power than 'larger suppliers' and 'suppliers of branded products'.

Qualitative evidence from suppliers on factors influencing supplier prices

9.16 Discussions with suppliers during the course of collecting our supplier pricing data indicate that influences on prices that an individual customer pays go beyond that customer's order size, and include:

- the history of the customer's purchases (eg whether it was a large customer in the past and therefore able to negotiate a favourable price that has been carried forward into subsequent dealings with the supplier);
- the future growth potential of the customer; and
- the promotional strategy of the customer.

These conclusions are broadly consistent with a qualitative assessment of supplier pricing issues based on interviews with the sales directors of eight branded goods suppliers of varying sizes submitted by [✂].[1]

Share of the retail price earned by grocery retailers relative to others in the supply chain

9.17 A number of parties told us that the fact that grocery retailers earned an increasing share of the retail price for various primary products suggested that they had buyer power. We analysed the share of the retail price earned by grocery retailers, intermediaries and primary producers in four primary products—milk, fresh fruit (apples, pears and strawberries), pig meat and red meat (beef and lamb)—and the different factors influencing those shares, particularly for primary producers.

9.18 This analysis found that in milk, red meat and fresh fruit, the proportion of the UK retail price captured by the primary producer has fallen over the ten years from 1997 to 2006, although there have been significant variations in these figures from year to year. However, there has been an increase in the proportion of the retail price of pig meat products captured by primary producers. For each of these product categories, the share of the retail price captured by processors over this period has typically been stable. For grocery retailers, the share of retail price has increased across all of these products with the exception of pig meat, where it seems to have declined, and beef, where the retailer share has been stable.

9.19 We placed limited weight on this data in our assessment of buyer power. We do not believe that the shares of the retail price for a particular product captured by the various segments of its supply chain are a useful indicator of the market power, since the shares are affected by many other factors.

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[1] [✂] study states that the 'majority of suppliers stated that "almost always" the largest customers would obtain the best trade terms'. It goes on to say that differences in the net price across grocery retailers would usually exceed 10 per cent, and that a substantial fraction of this difference would not show up in the headline or invoice price, but would be reflected in other payments by suppliers to grocery retailers. However, a number of caveats were placed on this finding. For example, faster-growing retailers with smaller overall volumes may achieve better prices from suppliers. Also, 'legacy' effects may mean that grocery retailers that previously had a favourable sales profile for suppliers might be able to maintain good prices based on the difficulties that suppliers face in making substantial price adjustments. Further, suppliers may be willing to encourage sales through wholesalers, and thus convenience retailers, through special deals, such as price-marked packages, thus facilitating price competition with the larger grocery retailers and so assisting sales volumes. Finally, some grocery wholesalers and smaller retailers may be able to achieve lower prices from suppliers through their use of promotion-led buying from suppliers in comparison with larger grocery retailers with 'every day low pricing' strategies.

Email correspondence between Asda, Tesco and their suppliers

9.20 Our review of emails between two grocery retailers (Asda and Tesco) and their suppliers during summer 2007, particularly our observations of their negotiating tactics, give the impression that Asda and Tesco have a strong position when negotiating with their suppliers. Full details of this review are set out in Appendix 9.1. This may explain, for example, observations such as a supplier providing product at below cost or paying for promotions proposed by a retailer that would otherwise be difficult to explain.

Findings regarding possession of buyer power

9.21 We conclude that, based on the size of grocery retailers, wholesalers and buying groups relative to suppliers, together with the evidence on supplier pricing and margins, all large grocery retailers, wholesalers and buying groups have buyer power in relation to at least some of their suppliers. However, we found that the buyer power of even the largest grocery retailers may be offset by the market power possessed by suppliers of the most prominent branded goods.

Performance and structure of the groceries supply chain

9.22 In the following paragraphs we review the groceries supply chain in terms of:

- supplier profitability and financial viability and its relationship to grocery retailers' buyer power;
- supplier investment and innovation and its relationship to grocery retailers' buyer power; and
- barriers to entry and expansion facing small suppliers of food and drink products.

Supplier profitability and financial viability

9.23 As we set out in paragraphs 9.3 to 9.5, grocery retailers' buyer power may have a detrimental effect on consumers if it leads to a reduction in investment and innovation by suppliers. It was also put to us that grocery retailers' buyer power could lead to a reduction in supplier profitability that could ultimately jeopardize the financial viability of the entire groceries supply chain. We examined the profitability of food and drink manufacturers to assess the likelihood of this outcome.

9.24 The evidence on profitability that we reviewed does not indicate a systematic problem with the financial viability of food and drink manufacturers during the period surveyed. We did not identify an ongoing decline in margins or return on capital for these companies. There is some evidence that margins for food and drink manufacturers have been adversely affected by rising commodity prices and other cost pressures. However, these increasing costs appear, at least in part, to be reflected in prices to final consumers (see paragraphs 3.40 to 3.41). Full details of this analysis are set out in Appendix 9.2.

9.25 For primary producers, the evidence in relation to their ongoing profitability is complex. In some sectors, such as dairy, significant numbers of farmers have exited the industry in recent years. However, incomes are increasing, particularly given recent farmgate price increases, for those that remain in this sector.

9.26 Our review of four key UK farming sectors—dairy, red meat, pig meat and fresh fruit—shows that a variety of factors have influenced returns for farmers in recent years (see Appendices 9.3 to 9.6). 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.

9.27 Increasing concentration at the intermediary level is likely to reduce bargaining power for farmers compared with grocery retailers and intermediaries. This has the potential to have an adverse effect on the incomes and profitability of UK primary producers, but other factors will continue to have an important influence on farming incomes. As we discuss in Section 8, increased concentration at the intermediary level may have implications for coordination among suppliers and grocery retailers.

Supplier investment and innovation

9.28 We reviewed trends in product innovation among grocery suppliers to assess whether this was being adversely affected by grocery retailers' buyer power. As part of our review we looked at: industry reports and studies on product innovation in the food and drink sector; results from the GfK supplier survey; and the number of new products being sold by the four largest grocery retailers each year.

9.29 The evidence that we reviewed does not indicate that there has been a declining trend in UK grocery suppliers' propensity to engage in product innovation over recent years (see Appendix 9.2). However, the interpretation of this evidence is not straightforward. First, product innovation is difficult to measure, and a number of factors other than grocery retailers' buyer power might affect suppliers' propensity to invest and innovate. Second, to the extent that the SCOP (see paragraph 2.6 and Appendix 9.7) has been constraining the conduct of the four largest grocery retailers, the effects of supply chain practices on suppliers' investment and innovation may not be apparent in data covering the period since 2003. Finally, as we explain in paragraph 9.5, a simple appraisal of the level of investment and innovation does not take account of the fact that levels of investment and innovation might have been even higher in a well-functioning market.

Barriers to entry and expansion for small suppliers

9.30 A concern raised during this investigation is that small suppliers may face barriers to entry or expansion in terms of gaining access to consumers through grocery retailers. Traidcraft, a supplier of fair trade grocery products, told us that the procurement policies of large grocery retailers forced suppliers either to remain small or to expand production greatly to levels that could support distribution by large grocery retailers. It also said that small suppliers faced other barriers to entry and expansion, such as national advertising costs.[1]

9.31 Grocery retailers, however, told us that they actively sought to develop small suppliers, and that new suppliers drove growth in product innovation and challenged the position of incumbent brands, and thereby helped the retailers' bargaining position with large suppliers of branded products. Waitrose told us of various initiatives to

[1]Traidcraft also raised concerns about the impact of competition from own-label products on suppliers of branded goods. We consider competition issues associated with own-label goods in paragraphs 9.71 to 9.81.

encourage small suppliers manufacturing a product that would initially be sold in one Waitrose store, and ultimately more widely. Morrisons told us that small suppliers were more likely to be niche suppliers, and suppliers of own-label products to grocery retailers. Where the small supplier is a specialist niche supplier, Morrisons told us that it benefited from long-term relationships with those suppliers rather than making demands on them that weakened their profitability.

9.32 While grocery retailers do not collect data on the size of their suppliers, the largest retailers have all recently listed new suppliers, indicating that there are at least some opportunities for small suppliers to gain access to consumers through grocery retailers. For example, for 2006:

- Asda told us that it listed [✂] new suppliers for a total of [✂] new product lines;
- Sainsbury's told us that [✂] new suppliers accounted for [✂] new product lines;
- Tesco told us that it dealt with [✂] new suppliers and [✂] new product lines (excluding non-food lines); and
- Waitrose told us that there were more than [✂] local products from [✂] local suppliers available in [✂] branches.

9.33 Grocery retailers told us that small suppliers of food and drink products typically faced barriers to entry and expansion arising from quality standards and other requirements relating, for example, to IT systems and distribution capabilities. However, grocery retailers also provided a number of examples of the support that they offered to small suppliers to overcome these barriers.[1]

9.34 Supply chain consolidation, encouraged by grocery retailers, may be a factor contributing to any decline in the number of small suppliers. Waitrose told us that most of the changes to its supplier base came as a result of consolidation, and we are aware of a number of mergers in the sector in recent years. We discuss supply chain consolidation further in paragraphs 3.35 to 3.38. Morrisons told us that as suppliers merged, there were always other niche suppliers entering the supply chain. Morrisons told us that it searched for niche suppliers within the UK and abroad because its customers increasingly demanded niche brands, not generic brands such as Kellogg's and Heinz.

9.35 Industry-wide data on both the number of small suppliers and their profitability (see Appendix 9.2) does not show an increasing prevalence of large suppliers. Between 2000 and 2004, margins for small food enterprises varied, and while, on average, they were lower than those of large food manufacturers, the difference between the average margins earned by the two groups narrowed over this period.

9.36 In summary, evidence at the aggregate level does not indicate a decline in the number of small suppliers participating in the supply chain, and we have not seen evidence to suggest that lump-sum payments to grocery retailers act as a significant barrier to entry or expansion for small suppliers.

[1]These included: training for small suppliers on factory hygiene, managing high-risk foods and controlling contamination; national and in-store promotions; online facilities and regional meetings to assist regional suppliers to meet retailer buyers and express difficulties; acceptance of lower than usually desired quantities of product; shorter payment terms if the supplier's business has a particular need for cash flow; dedicated small supplier teams; delivery to a single location rather than multiple depots; a commitment to minimum trial periods; access to sales information; and the provision of online facilities to assist suppliers to help each other and aggregate the supply of local products.

Behaviour of grocery retailers towards their suppliers

9.37 In the following paragraphs we examine different aspects of the behaviour of grocery retailers towards their suppliers and assess the extent to which this conduct might have an AEC. In particular, we consider:

- supply chain practices;
- demand withholding; and
- the sale of own-label products.

Supply chain practices

9.38 In analysing whether supply chain practices carried out by grocery retailers might have an AEC, we examined the link between various practices and investment and innovation by grocery suppliers, and then reviewed evidence on the nature and extent of different supply chain practices.

9.39 In looking at supply chain practices, we considered both price and non-price aspects of the commercial relationships between grocery retailers and wholesalers and suppliers. Non-price aspects include, for example, the general terms and conditions of supply, and support payments from suppliers to grocery retailers. In terms of prices, we have been most concerned with issues surrounding the timing of any change in prices, and in particular, the extent to which grocery retailers impose retrospective changes in prices.

Supply chain practices and the link to supplier investment and innovation

9.40 Grocery suppliers must make investments in an uncertain commercial environment where, for example, demand may fall or costs may rise unexpectedly. Suppliers will decide whether to undertake investment by estimating the likely returns and balancing this against the risks involved. The supply chain practices of grocery retailers may have an important bearing on this calculation in terms of the degree of risk that a supplier faces in undertaking the investment, and the uncertainty arising from these practices has the potential to diminish significantly suppliers' incentives to invest in new products, capacity or production processes.

9.41 Competition at the retail level leads grocery retailers to seek the best terms and conditions from their suppliers. The possession of buyer power by a grocery retailer allows grocery retailers to extract lower prices from suppliers than would otherwise be the case, and consumers benefit as a result of these lower wholesale prices being reflected in lower retail prices. However, when, in the hope of gaining a competitive advantage, grocery retailers transfer excessive risks or unexpected costs to their suppliers through practices involving retrospective adjustments to supply agreements or giving rise to moral hazard on the part of the grocery retailer, this is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. If unchecked, these practices, which are essentially a side-effect of competition between grocery retailers with buyer power, will be detrimental to the interests of consumers.

9.42 An illustration of this effect was provided by [✄], which told us, in explaining an incident of inappropriate buyer behaviour towards one of its suppliers, that the buyer was 'under a lot of pressure and stress because … it was such a tough sales period'. ([✄] told us that it considered the language used in the email concerned was inappropriate and has trained the buyer not to use this kind of language in the future. [✂] also noted that none of the suppliers that were sent this email responded to the proposal that it contained.) More generally, [✂] told us that retailing was a stressful business and that buyers were under pressure, particularly if sales were not moving in the way they would want. In our view, this illustrates the pressures that are likely to lead to the transfer of excessive risks and unexpected costs to suppliers.

9.43 A number of grocery retailers ([✂]) said that it was in their interest to ensure that suppliers invested in new capacity, products or production processes. While we agree that it might be in the long-term interest of the grocery retailers to ensure that suppliers invest and innovate, this long-term incentive is overshadowed by the short-term necessity of extracting the best possible terms and conditions from suppliers so as to compete effectively with other grocery retailers. Further, a grocery retailer may have less interest in trading on favourable terms with a supplier if the benefit of supplier investment and innovation was also reaped by other grocery retailers that were not trading with the supplier on such favourable terms.

9.44 Our concern is not with the transfer of risks or costs *per se* between grocery retailers and suppliers, but with the transfer of excessive risks or unexpected costs that may affect suppliers' willingness to invest or innovate. In deciding which supply chain practices might give rise to the transfer of excessive risks or unexpected costs, we had regard to the complaints submitted to us by suppliers regarding grocery retailers' conduct and the evidence from suppliers as to the supply chain practices that would be most prone to reduce their investment or innovation.

9.45 We concluded that the principal manner in which excessive risks or unexpected costs can be transferred from grocery retailers to suppliers is through retailers making retrospective adjustments to the terms of supply. We are concerned, in particular, with retrospective changes to previously agreed supply arrangements in favour of retailers which will almost always create additional uncertainty, shifting risk and added costs to suppliers. For example, a requirement for a price adjustment after goods have been ordered or after products have been delivered is a typical practice that is a source of unexpected costs to suppliers. Similarly, requirements for financing or promotions that were not agreed with the suppliers are also retrospective adjustments that are a source of uncertainty.

9.46 In our view, such retrospective adjustments are likely to diminish significantly suppliers' incentives to fund investments for the development of new products or improved production processes. It is because suppliers come to expect that these retrospective changes might take place that they may become reluctant to launch new investment projects. The level of uncertainty will increase as suppliers become unable to determine the nature of these unexpected adjustments, or their frequency, or to quantify their impact on future earnings.[1]

[1]We received submissions from a number of parties with respect to the time beyond which changes become retrospective, and the extent to which adjustments that are agreed up-front and have retroactive effect can be described as 'retrospective'. In our view, where a retailer and a supplier have concluded an agreement for the supply of goods, any subsequent unexpected unilateral change of the contractual terms governing the provision of those particular goods is generally not appropriate when the supplier has itself already sunk significant costs in order to meet the objectives set out in the agreement. Even when the renegotiation occurs prior to delivery of the goods and acceptance of them by the retailer, it is likely that a supplier will have taken irrevocable steps as a result of the contract. However, where a contract sets out expressly and unambiguously in advance the basis on which retroactive adjustments to the terms of supply can occur, a resulting adjustment ought not to be considered retrospective. In that instance, risk has been agreed and shared between the parties prior to the transaction. For example, if an erroneous sales forecast by the retailer results in significant overstocking of a product, it would not be appropriate for the retailer to then request or require that the supplier share the costs of a promotion to increase demand. However, if the contract had specified that in the event of a forecasting error, the supplier would bear a pre-specified price reduction, then the contract would have allocated the risk prior to the transaction taking place. (Clause 7 of the SCOP, which regulates payments for wastage, is an example of an existing clause which stipulates prior agreement as to allocation of risk.) A term of an agreement between a retailer and a supplier which permitted the retailer to request or require an unspecified retroactive allocation of risks and costs in a wide range of circumstances should, in our view, still be regarded as [*(cont'd overleaf)*]

9.47 In addition to retrospective adjustments to the terms of supply, we also concluded that there are circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier is excessive. We have particular concerns regarding the transfer of risk from grocery retailers to suppliers in situations where this transfer creates a 'moral hazard'; that is, where the retailer has the ability to affect the degree of risk incurred, but as a result of the transfer, the retailer has less incentive to minimize that risk. In these situations, the transfer of risk increases the total risk borne by the parties, and also increases the costs to the supplier.

9.48 For example, we saw that at least one grocery retailer imposes liability on some of its suppliers for losses suffered as a result of shrinkage (ie losses that arise where stock is recorded on a company's books but is not on hand, due to theft, the goods being lost or accounting error). In our view, the party best placed to control risks arising through shrinkage is the retailer (eg by improving security at depots or stores, or improving stock accounting procedures); in the vast majority of cases, the supplier has no capacity to address shrinkage losses suffered by the retailer.[1]

9.49 We were also told of instances where grocery retailers have imposed sizeable charges on suppliers in respect of customer complaints regarding the suppliers' products, but have not given those suppliers an opportunity to verify the basis for the complaint (or the fact that responsibility for the complaint lay with the supplier). We have concerns that in the absence of an obligation to provide proof to the supplier that the charge was properly incurred, retailers will have an incentive to over-compensate customers, at the expense of suppliers.

Categorization of supply chain practices

9.50 In assessing the supply chain practices of grocery retailers we started with the 52 practices identified in the 2000 investigation (see Appendix 9.8). This covers the majority of the practices raised with us during our current investigation. Those practices raised with us that do not strictly fall within those specified in this list are generally variations on the practices identified in the 2000 investigation.

9.51 We categorized the 52 practices as follows:

(a) category management practices of grocery retailers (3 practices);

(b) possible coordination between grocery retailers or between grocery retailers and their suppliers (2 practices);

(c) supply of own-label goods by grocery retailers (1 practice);

(d) actions by grocery retailers aimed at influencing the costs of supply or product availability for competing grocery retailers (5 practices);

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retrospective. In order not to be retrospective, such a clause would need to be sufficiently specific as to the circumstances in which it would be triggered and the allocation of risks and costs that would apply, so that it is clear that both the retailer and the supplier have had the opportunity to consider the apportionment of risk and cost before entering into the contract.

[1]A number of retailers suggested to us that for certain small, high-value products (such as batteries and razor blades), manufacturers were in a position to affect the risk of shrinkage, for example by including security features in packaging. We accept that for a small number of products, the risk of shrinkage can be influenced by the manufacturer, although for these products, there are also steps that the retailer can and does take, such as storing the products close to the till or in tamper-proof cartridges. For this small number of products, we would expect the grocery retailer to prescribe particular packaging if it had decided that this was the most effective means of controlling shrinkage. In such a case, there is no need for the supplier to bear ongoing risk.

(e) product mislabelling or other practices that might mislead consumers regarding the nature of a product sold by a grocery retailer (3 practices);

(f) lump-sum payments by suppliers to grocery retailers (4 practices);

(g) practices that have the potential to create uncertainty for suppliers regarding their revenues or costs as a result of the transfer of excessive risks or unexpected costs to suppliers (26 practices); and

(h) practices in a range of areas, such as price negotiations, that we do not consider raise concerns in terms of preventing, restricting or distorting competition (9 practices).

9.52 We analyse categories *(a)* to *(c)* separately in this report (see Section 8 regarding coordination and category management, and paragraphs 9.71 to 9.81 regarding own-label goods).

9.53 We find that product mislabelling or the provision of misleading information or claims with respect to product characteristics might distort competition between grocery retailers (category *(e)* in paragraph 9.51). However, while a number of parties have raised concerns in this area, we did not see sufficient evidence to indicate that these practices are widespread.

9.54 In relation to actions by grocery retailers aimed at influencing the costs of supply or product availability for competing grocery retailers (category *(d)* in paragraph 9.51), we find that a number of individual practices within this category would distort competition between grocery retailers. However, the evidence that we reviewed does not indicate that these practices are widespread.

9.55 We found that a significant number (26) of practices identified in the 2000 investigation have the potential to result in the transfer of excessive risks or unexpected costs from grocery retailers to suppliers. In some cases, the impact of these practices will depend on the specific way in which the practice is carried out by a grocery retailer. In other cases, certain practices will almost always have this effect. Requirements for retrospective price adjustments, retrospective financing of promotions, or other practices that effectively result in a retrospective adjustment to previously agreed supply arrangements, for example, will always be a source of uncertainty for suppliers.

9.56 Other practices appear acceptable on their face, but are also open to exploitation by grocery retailers as a means of effectively lowering the price paid to suppliers or transferring excessive risks to suppliers. For example, it may be quite legitimate for a grocery retailer to deduct sums from a supplier invoice where the supplier has not provided goods to the correct specification or as otherwise agreed between it and the grocery retailer. However, withholding payment either without cause or on a spurious basis may also be a means of imposing unexpected costs on suppliers.

Evidence of supply chain practices

9.57 The evidence that we reviewed on supply chain practices arises principally from three sources:

- matters raised with us during the course of our investigation by both individual suppliers and suppliers' associations, including material collected through the use of our powers under section 109 of the Act to compel the provision to us of relevant information by these organizations (see Appendix 9.9);[1]

- the GfK supplier survey; and
- finally, our review of emails between each of two grocery retailers (Asda and Tesco) and their suppliers during summer 2007 (see Appendix 9.1).

9.58 Any consideration of supply chain practices must take into account the existence of the SCOP, which was established as a result of the 2000 investigation (see paragraph 2.6 and Appendix 9.7), and regulates the supply chain practices of the four largest grocery retailers. We have not carried out a review of retailers' compliance with the SCOP. However, in 2005 the OFT arranged for an audit of retailers' compliance with the SCOP, which did not identify widespread evidence of breaches. Several provisions of the SCOP concern practices which could result in the transfer of excessive risks or unexpected costs from retailers to suppliers (although the SCOP does not cover all such practices). Given the existence of the SCOP, we would expect supply chain practices which transfer excessive risks or unexpected costs to suppliers to be less prevalent than would otherwise be the case.

9.59 Of the 380 concerns raised with us 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 us from discussing details of individual complaints with the grocery retailers. This means that we are unable to form a definitive view on each individual matter that has been brought to our attention. We are, however, able to form a general impression regarding the overall prevalence and relative extent of these practices.

9.60 As part of the GfK supplier survey, information was collected from suppliers regarding a number of practices addressed under the SCOP that we also found may lead to uncertainty for suppliers over future earnings. Table 9.3 shows that one-third to one-half of suppliers experience practices such as payment delays, excessive payments for customer complaints, and retrospective price adjustments.[2]

[1]One of the difficulties that we faced when examining competition issues in the groceries supply chain was the reluctance of suppliers to provide us with details of specific instances of conduct by grocery retailers that illustrated the general concerns that were being raised. Following the publication of Emerging Thinking in January 2007, in which we drew attention to the apparent reluctance of suppliers to give evidence to us, we took steps to reassure suppliers that we would be able to receive their evidence regarding grocery retailers' conduct without damaging their commercial relationships with those retailers. We also made use of our statutory powers to compel the provision of information by a number of industry associations, individual suppliers and grocery retailers. As a result, we are satisfied that we have sufficient evidence on which to make findings in relation to these issues.

[2]The proportion of suppliers to the four grocery retailers covered by the SCOP which reported various practices carried out by grocery retailers in the past five years was somewhat lower in each case.

TABLE 9.3 **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.

9.61 We noted the results of a survey of 50 UK grocery suppliers conducted by Grant Thornton,[1] which discussed the effect of commercial uncertainty on suppliers to large grocery retailers and corroborated some of the results reported in Table 9.3. The Grant Thornton survey reported that:

- 31 per cent of suppliers felt that an order from a large grocery retailer was 'secure' only when the goods had been delivered to the retailer, and 4 per cent considered that it was secure only when the retailer had made payment.

- 24 per cent of suppliers reported that they had experienced unexpected last-minute changes or cancellations and had received no form of compensation from the retailer concerned.

- Only 50 per cent of suppliers felt highly confident, at the time of delivery, that the sale price would not be reduced by retrospective contributions sought.

9.62 We sought the views of six grocery retailers (Asda, CGL, Morrisons, Sainsbury's, Somerfield and Tesco) regarding certain practices that had been brought to our attention in relation to that retailer. In general, we were told that the practices to which we referred were either not covered by the SCOP or were carried out in a manner consistent with the SCOP. The grocery retailers considered that none of the practices raised had an AEC. Further details of the grocery retailers' comments on specific practices are included in Appendix 9.8.

9.63 In the Asda and Tesco correspondence case study in Appendix 9.1, the correspondence we reviewed suggested that at least 20 of the 52 practices identified in the 2000 investigation continued to be practised. However, this does not imply that this correspondence is evidence of breaches of the SCOP, since, in most cases, the SCOP regulates a practice (eg requiring that the retailer undertake the practice reasonably) rather than prohibiting it outright. A number of these 20 practices could, in certain circumstances, have the effect of transferring excessive risks or unexpected costs to suppliers.

9.64 In relation to promotions (see paragraphs 15 to 18 of Appendix 9.1), based on the correspondence that we reviewed, we found that suppliers can come under intense pressure to agree to fund promotions, sometimes at very short notice. In some instances, this may be viewed as a negotiation tactic by a retailer to reduce the costs of wastage. In this way, a grocery retailer might shift the burden of some of the cost of over-ordering back to the supplier by requesting support for a promotion, which

[1]Grant Thornton UK LLP (2007), *Redressing the balance: Forging a more certain future for the UK grocery supply chain*.

could be regarded as a transfer of the risk arising from over-ordering by the retailer. We observed some examples of suppliers providing 65 per cent of the funds for a promotion, and strongly-worded requests from a retailer for promotional support.

9.65 The correspondence provided examples of retailers levying an agreed flat-rate charge in instances of wastage, as permitted under the SCOP (see paragraphs 19 to 21, Appendix 9.1). Asda, for example, increased the flat rate it charges for customer complaints it considers to be the fault of the supplier from £[✂] to £[✂]. We would have concerns about the level of these flat-rate fees, and their impact on the apportionment of risk between retailer and supplier, in circumstances where: their level was grossly disproportionate to the loss suffered by the retailer; the fee was imposed where the wastage was not the fault of the supplier; or the supplier was not provided with an opportunity to review the evidence and confirm that the fee had been legitimately charged.

9.66 On balance, we concluded that supply chain practices that transfer excessive risks and unexpected costs to suppliers, including through the use of retrospective payments and other adjustments to supply agreements, are sufficiently prevalent to cause concern. Further, given that the SCOP appears to be constraining the exercise of buyer power by the grocery retailers to which it applies (see Table 9.3), we decided that any removal of the SCOP would allow these grocery retailers to exercise their buyer power in a way that would further transfer excessive risks and unexpected costs to suppliers.

9.67 As we set out in paragraph 9.38, our key concern with supply chain practices is their impact on suppliers' willingness to invest, given the uncertainty that they create and the consequent impact of this lack of investment on product quality and innovation. While current trends in, and levels of, product innovation may not indicate a cause for concern, we must also have regard to whether product innovation performance might be better in other circumstances or if we can expect this level of product innovation to continue in the future. Although we cannot quantify the future effect of the supply chain practices that we currently observe from the evidence that we have collected, the evidence that we reviewed suggests that the prevalence of these practices is increasing (Table 9.3). We are concerned that current levels of innovation or investment would not be maintained in the future were the practices that we observe to continue.

Demand withholding

9.68 Some suppliers and supplier trade associations expressed concerns regarding the possibility of demand withholding, whereby grocery retailers withhold demand from suppliers at times where suppliers face increasing unit costs and diminishing returns (that is, a situation where the cost per unit of supplying an extra unit of production is increasing).[1] In theory, where retailers have market power with respect to their customers, demand withholding would be a profitable strategy for retailers, by allowing them to benefit from lower wholesale prices from suppliers and, at the same time, to increase prices for consumers.

9.69 We received no specific allegations of demand withholding activities on the part of grocery retailers. One likely candidate sector for demand withholding is fresh fruit. However, having reviewed industry cost structures, as well as recent purchasing patterns and retail prices, in the fresh fruit sector, we did not find any evidence to

[1]Diminishing returns are particularly likely to arise from time to time for primary producers, since increased production will tend to involve more intensive use of land.

support a finding that demand withholding was taking place. Further details of our analysis are included in Appendix 9.6.

9.70 In summary, we found no evidence of demand withholding being undertaken by UK grocery retailers.

Sale of own-label products by grocery retailers

9.71 Two concerns were raised in this investigation regarding competition issues in the groceries supply chain that might arise from the sale of own-label products by grocery retailers. These relate to: grocery retailers' position as customers and competitors of brand manufacturers; and the use of copycat packaging for own-label goods.[1]

9.72 In relation to the first issue, it was put to us that large grocery retailers controlled an increasingly significant proportion of retail sales of groceries, and were therefore vital commercial customers for branded manufacturers, but that at the same time, these grocery retailers competed with branded manufacturers by selling own-label ranges.

9.73 It was suggested to us that, in occupying both these roles, grocery retailers enjoyed significant competitive advantages in their capacity as suppliers of own-label ranges, through their ability to control branded product manufacturers' access to market, the prices at which those branded goods were sold and their rates of sale (through shelf position and size), as well as the availability of opportunities for in-store communications and promotions. In addition, it was suggested that retailers were in a position to demand access to commercially-sensitive marketing and product information ahead of a product's launch, which could then be used by those retailers in the development of their own-label products. The exploitation by retailers of such a position could, in theory, reduce the ability of brand owners to realize a return on product innovation, and might lead to lower levels of investment into new products in the future.

9.74 We examined a number of data sources relating to the performance of own-label goods and levels of innovation in branded products. Full details of our analysis are in Appendix 9.10. However, in summary, if grocery retailers possessed a decisive advantage in competing with branded manufacturers, we would expect to see a trend towards an increasing share of sales for own-label products.

9.75 The sale of own-label products as a share of total grocery sales has increased substantially overall since their widespread introduction in the 1960s. However, at a product category level, there are quite different levels of own-label penetration within different categories, and, over time, own-label sales as a share of total sales have increased and decreased in different product categories. Research suggests that the advantages that grocery retailers have in selling own-label products are not sufficient to ensure growth at the expense of branded products.[2]

9.76 The variable trends in the share of sales of own-label products in different product categories are consistent with there being a number of different factors driving branded and own-label sales. Some of these factors are influenced exclusively by the branded product manufacturer, while others are influenced by the grocery retailer.

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[1]This behaviour consists of selling own-label products with packaging which closely resembles the packaging of a rival branded product.
[2]Mintel, *Own-label food and drink intelligence*, October 2006.

9.77 Our review of product innovation in Appendix 9.2 indicates levels of R&D expenditure by grocery suppliers which suggest that the sale of own-label products by grocery retailers has not had any adverse effect on product innovation by branded product manufacturers to date. Further, it is not clear that innovation is concentrated among branded product manufacturers.

9.78 Copycat packaging of own-label products is another concern that has been raised in relation to the competitive impact of own-label products on branded products and their manufacturers. In particular, some parties have submitted that copycat packaging might induce consumers to purchase mistakenly own-label products, since similar packaging can lead consumers to think that the own-label product is the same as the branded version, that it is produced by the same company, or that it is of similar quality.[1] It is argued that this practice could distort competition between grocery retailers and grocery suppliers, or even between grocery retailers.[2]

9.79 The importance of packaging and its similarity to branded products is a key driver of own-label success, among several other primary and secondary drivers.[3] However, given the repeat purchases involved with most grocery products, packaging on its own is unlikely to provide a sustained basis for the success of an own-label product when competing with a branded product, and is more likely to be a deliberate choice by customers. Therefore, we concluded that any sustained negative effect on competition is unlikely to result from copycat packaging.[4]

9.80 Own-label products may also have the potential to reduce consumers' ability to compare the offer of different retailers and thus lessen price competition between retailers. This concern is based on a view that only branded goods can be readily compared across retailers. This is because while branded goods can be found in the same form at each grocery store, the specification of own-label products varies between retailers. However, we found that the introduction of own-label products does not necessarily lead to a lessening of competition between grocery retailers in relation to those products. While the specification of own-label products is likely to vary between retailers, we concluded that consumers are able to make comparisons between the own-label products of different grocery retailers, taking into account price and quality.

9.81 We concluded that the sale of own-label products by grocery retailers does not give rise to an AEC.

Conclusions on competition issues in the supply chain

9.82 We conclude that, based on the size of grocery retailers, wholesalers and buying groups relative to suppliers, together with the evidence on supplier pricing and margins, all large grocery retailers, wholesalers and buying groups have buyer power in relation to at least some of their suppliers. However, we found that the buyer

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[1] The use of copycat packaging is limited by both trade-mark laws and the law on 'passing off'. Passing off is a common law right of action and provides a remedy to businesses which do not own registered trade marks but want to stop a third party from copying their product. However, we have been told that these laws are insufficient to prevent copycat packaging.
[2] See P Dobson, *The Competition Effects of Look-alike Products*, University of Nottingham, 1998.
[3] See J Steenkamp, I Geyskens, K Gielens and O Koll, *A global study into drivers of private label success*, report commissioned by AIM, the European Brands Association, 2004.
[4] An academic review in 1999 of more than a dozen different studies of consumer confusion between own-label and branded products concluded that the 'evidence for confusion is therefore inconclusive. While some degree of association appears to be drawn from packaging, evidence of outright confusion and mistaken purchase is less clear': S Burt and S Davis, 'Follow my leader? Lookalike retailer brands in non-manufacturer-dominated product markets in the UK', *The International Review of Retail, Distribution and Consumer Research*, 9:2, April 1999, pp163–185.

power of even the largest grocery retailers may be offset by the market power possessed by suppliers of the most prominent branded goods.

9.83 Grocery retailers' buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices. We do not find that the financial viability of food and drink manufacturers was under threat as a result of the exercise of buyer power by grocery retailers. However, when, in the hope of gaining a competitive advantage, grocery retailers transfer excessive risks or unexpected costs to their suppliers, this is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. If unchecked, we conclude that these practices will ultimately have a detrimental effect on consumers.

9.84 We conclude that the principal manner in which excessive risks or unexpected costs can be transferred from grocery retailers to suppliers is through retailers making retrospective adjustments to the terms of supply. We also conclude that there are circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but that the extent of risk transferred to the supplier is excessive. We also have concerns regarding the transfer of risk from grocery retailers to suppliers in situations where this transfer creates a 'moral hazard'; that is, where the retailer has the ability to affect the degree of risk incurred, but as a result of the transfer, the retailer has less incentive to minimize that risk.

9.85 While the evidence that we reviewed does not indicate that there has been a declining trend in UK grocery suppliers' product innovation over recent years, it is difficult to draw conclusions given the different influences on investment and innovation. We expect that the investment and innovation performance that we currently observe in the groceries supply chain would have been even better in the absence of the practices that we observe. Further, the SCOP does appear to be constraining the exercise of buyer power by the four largest grocery retailers to some extent, and its removal would allow these grocery retailers to exercise their buyer power in a way that would further transfer excessive risks and unexpected costs to suppliers. We are also concerned with the levels of investment and innovation that might be realized in the future were the supply chain practices that we currently observe to continue.

9.86 We found that product mislabelling or the provision of misleading information, as well as actions by grocery retailers aimed at influencing the costs of supply or product availability for competing grocery retailers, could distort competition between grocery retailers. However, the evidence we have reviewed does not indicate that these practices are widespread.

9.87 We did not find evidence that there are significant barriers to entry or expansion for small suppliers, or that grocery retailers are engaging in demand withholding as a means of driving down supplier prices. Further, we concluded that the sale of own-label products by grocery retailers did not give rise to an AEC.

10. Findings and features

10.1 In conducting this investigation we reviewed a large amount of evidence and received a wide range of views on the state of competition in UK grocery retailing. We found 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 found that there are features that prevent, restrict or distort competition in connection with how grocery retailers compete in local markets and in their relations with suppliers. We also noted that possible anti-competitive conduct on the part of certain grocery retailers is under investigation by the OFT.

10.2 Where barriers to entry are present, a grocery retailer with few competitors or a high market share will face a weaker competitive constraint from other grocery retailers. Between 11 and 27 per cent of larger grocery stores and between 10 and 22 per cent of mid-sized and larger grocery stores are in highly-concentrated local markets. We conclude that consumers are adversely affected by local markets being highly concentrated rather than more competitive. Weak competition in local markets allows a grocery retailer to worsen the store-specific retail offer at its stores in those markets and earn higher profit margins at those stores. In addition, a grocery retailer with a number of stores in local markets where competition is weak is able to weaken that part of its retail offer, such as pricing, that it applies uniformly, or near uniformly, across its stores nationally and thereby earn high profits across all of its stores.

10.3 We found that there are barriers to entry that constrain competition by impeding the emergence of competitors able to challenge the officer of existing grocery retailers. The planning system, in pursuing the broad-based objectives for which it is intended, necessarily constrains entry by new larger grocery stores. The costs associated with site assembly and submitting a planning application, and the risk of planning permission not being granted, mean that existing large grocery retailers with substantial experience of the planning system are in a better position to mitigate or absorb these costs and risks than other grocery retailers and new entrants.

10.4 Further, the shortage of land available for new larger grocery stores, arising in part from the planning system, means that the control of this land by grocery retailers in certain highly-concentrated local markets frustrates new entry that would strengthen competition. We found that 93 controlled landsites act as a barrier to entry in highly-concentrated local markets and have an AEC. These included 19 land bank sites, 32 restrictive covenants, 30 exclusivity arrangements and 12 landsites that are leased or sub-leased to third parties.

10.5 We found that all large grocery retailers, wholesalers and buying groups have buyer power in relation to at least some of their suppliers. This buyer power is of benefit to consumers since part of the lower supplier prices arising from this buyer power will be passed on to consumers in the form of lower retail prices. However, we found that when, in the hope of gaining competitive advantage, grocery retailers transfer excessive risks or unexpected costs to their suppliers, this is likely to lessen suppliers' incentives to invest in new capacity, products and production processes. If unchecked, we conclude that this will ultimately have a detrimental effect on consumers, by leading to lower-quality goods, less choice of goods, or less product innovation.

10.6 We do not focus here on the findings that have not led us to identify features that have an AEC. There is, however, one particular issue which has been raised with us by many parties as a matter of concern and which extends over many of the individual areas that we have investigated, namely the strong market position of Tesco. We did not find there to be competition concerns that apply to Tesco over and above those that apply to other grocery retailers. There would obviously be cause for concern if any one retailer were able to achieve and exploit significant market power to the detriment of consumers. Our assessment is 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 shielded from competition increases and there would be further deterioration of the retail offer that would harm local consumers and consumers in general. Such a development could also take place with any other large retailer. We expect our remedies to contribute to preventing such a situation occurring.

Features which prevent, restrict or distort competition

10.7 As discussed in paragraph 1.2, under section 134(1) of the Act, we are required to decide whether 'any feature, or combination of features, 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'. A feature can take the form of the structure of a market and/or conduct on the part of the grocery retailers or their customers. As noted above, we can consider either individual features or a combination of features of a market. In identifying any such features of a market, we seek to compare the levels of competition that we observe with those which we might reasonably expect to find in a well-functioning market.

10.8 We identified separate product markets for: the supply of groceries by larger grocery stores; the supply of groceries by mid-sized and larger grocery stores; and the supply of groceries by all grocery stores, including convenience stores. We found that the geographic markets for grocery retailing are local.

10.9 We find that a combination of one or more of the following features of certain local markets for the supply of groceries by larger grocery stores prevent, restrict or distort competition in connection with the supply of groceries by larger grocery stores in those markets:

(a) A significant number of local markets have high levels of concentration, and these high levels of concentration have in many cases persisted over a number of years.

(b) The planning regime (in particular, PPS6 in England, SPP8 in Scotland, PPS5 in Northern Ireland and MIPPS 02/2005 in Wales) and its application by Local Planning Authorities in accordance with the policy objectives of the planning regime necessarily act as a barrier to entry or expansion in a significant number of local markets:

(i) by limiting construction of new larger grocery stores; and

(ii) by imposing costs and risks on smaller retailers and entrants without pre-existing grocery retail operations in the UK that are not borne to the same extent by existing large grocery retailers.

(c) The control of land by incumbent retailers through land bank sites, restrictive covenants, exclusivity arrangements, and landsites that are leased or sub-leased to third parties in highly-concentrated local markets acts as a barrier to entry, by limiting entrants' access to potential sites for new larger grocery stores.

10.10 We find that a combination of one or more of the following features of certain local markets for the supply of groceries by mid-sized and larger grocery stores prevent, restrict or distort competition in connection with the supply of groceries by mid-sized and larger grocery stores in those markets:

(a) A significant number of local markets have high levels of concentration, and these high levels of concentration have in many cases persisted over a number of years.

(b) The control of land by incumbent retailers through land bank sites, restrictive covenants, exclusivity arrangements, and landsites that are leased or subleased to third parties in highly-concentrated local markets acts as a barrier to entry, by limiting entrants' access to potential sites for new mid-sized and larger grocery stores.

10.11 We find that the exercise of buyer power by certain grocery retailers in relation to their suppliers of groceries, through the adoption of supply chain practices that transfer excessive risks and unexpected costs to those suppliers, is a feature of the markets for the supply of groceries by all grocery stores, which prevents, restricts or distorts competition in connection with the acquisition of groceries by large grocery retailers and some wholesalers and buying groups.

10.12 We therefore find, on the statutory questions that we have to decide pursuant to section 134(1) of the Act, that there is one or more AECs within the meaning of section 134(2). The features are those that we identify in paragraphs 10.9 to 10.11.

Detrimental effects on consumers and the need for remedies

10.13 The detrimental effects on consumers arising from the features identifed in paragraphs 10.9 to 10.11 primarily take the form of a poorer retail offer for consumers at mid-sized and larger grocery stores. This poorer retail offer includes higher national prices as well as lower levels of service, quality and other non-price aspects of the retail offer. Consumers also experience a more limited choice of stores than would otherwise be the case. The features that we identify in relation to the groceries supply chain, if unchecked, are expected to have a detrimental effect on consumers through, in large part, poorer-quality products and less product innovation.

10.14 It is difficult to estimate directly the scale of consumer detriment arising from these features. We are, however, able to estimate, to some degree, the additional profits that grocery retailers earn as a result of weak competition. We estimate that the effect of weak local competition on store-level profit margins allows large grocery retailers to earn an additional £105–£125 million in profits a year at their larger grocery stores. This represents around 3 per cent of annual profits for the four largest grocery retailers. The additional store-level profits at mid-sized grocery stores as a result of weak local competition may be of a similar order.

10.15 Weaknesses in local competition also result in higher national prices than would otherwise be the case. The scale of the impact on national price levels arising from weak local competition, while difficult to measure, is potentially very substantial. For example, for each 0.1 per cent increase in national price levels, consumer expenditure on groceries at the four largest grocery retailers increases by £80 million a year.

10.16 Concerning the supply chain, it is difficult to place a value on the cost of lost investment and innovation that would happen in the future. However, the value of the groceries supply chain is of the order of £70 billion in annual sales to grocery retailers. The scale of the groceries supply industry is such that even a small loss in investment and innovation, and its impact on product quality and choice, is likely to have a significant detrimental impact on consumers.

10.17 Given these considerations, we consider that the detrimental effect on consumers arising from the features we have identified are sufficient to justify remedial action. We set out in Section 11 our decision on remedies and discuss further the proportionality of these remedies in the light of the consumer detriment that we have identified.

11. Remedies

Overview

11.1 We now consider measures to remedy, mitigate or prevent the AEC, or resulting detrimental effects on customers, as set out in our findings and conclusions in

Section 10 of this report. This section describes our consideration of evidence relating to each individual remedy and to remedies in general, and sets out our decisions on remedies.

11.2 On 30 October 2007, we issued a Remedies Notice which invited comments on the actions that might be taken to remedy, mitigate or prevent the AEC, or resulting detrimental effects on customers, identified in our provisional findings of the same date. A copy of the Remedies Notice is published on our website.[1] We received a large number of responses to the Remedies Notice, held further hearings and staff meetings with parties and undertook further analysis of possible remedies. In the light of this evidence, we published our Provisional Decision on remedies on 15 February 2008. Our remedies assessment takes account of the responses to the Remedies Notice, and of the responses to our Provisional Decision on remedies, and the other evidence on remedies that we received during our investigation.

11.3 We next set out our framework for the assessment of remedies (see paragraphs 11.4 to 11.10). We assess possible remedies to address local market concentration including remedies in relation to *(a)* the planning regime as it applies to grocery retailing (see paragraphs 11.12 to 11.135); *(b)* the control of land by large grocery retailers (see paragraphs 11.136 to 11.255); and *(c)* highly-concentrated local markets where a grocery retailer with a strong local market position has more than one store in that local market (see paragraphs 11.256 to 11.268). We also assess possible to address supply chain practices (see paragraphs 11.269 to 11.376). Finally, we discuss the proportionality of the remedies to the AECs (see paragraphs 11.377 to 11.422); consider whether we should modify our chosen remedies having regard to any relevant customer benefits (see paragraphs 11.243 to 11.436) and summarize our remedies decisions (see paragraphs 11.437 to 11.449).

Framework for the assessment of remedies

11.4 Under section 134(4) of the Act, if the CC has decided that there is an AEC, it should decide the following additional questions:

(a) whether action should be taken by us for the purpose of remedying, mitigating or preventing the AEC concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the AEC;

(b) whether we should recommend the taking of action by others for the purpose outlined in *(a)* above; and

(c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.

11.5 In choosing appropriate remedial action, the CC has a statutory obligation to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any detrimental effect on customers so far as resulting from the AEC.[2]

11.6 As noted in our guidance (*CC3*, paragraph 4.9), we must consider the effectiveness of different remedies and their associated costs and will have regard to the principle of proportionality when deciding on appropriate remedies. Our guidelines outline several factors relevant to our consideration of effectiveness (*CC3*, paragraph 4.13 and following). First, an effective remedy will make clear the persons to whom it is

[1] www.competition-commission.org.uk/inquiries/ref2006/grocery/index.htm.
[2] Section 134(6) of the Act.

directed and any other persons who might be interested in it. Second, we should consider the prospects of a particular remedy being implemented and complied with. A third relevant consideration is the time period within which the remedy will be effective. Other factors may also be relevant to our consideration of effectiveness, depending on the facts of the case.

11.7 In considering whether a remedy is reasonable and practicable, we should consider its implementation costs (*CC3*, paragraph 4.10). We should endeavour to minimize any ongoing compliance costs to the parties, provided the effectiveness of the remedy is not reduced (*CC3*, paragraph 4.12). However, we should balance those costs against the benefit to the UK economy and to customers in particular.

11.8 We should also take account of the proportionality of any remedies or package of remedies in relation to the AEC and any resulting detrimental effect on customers. If we are choosing between two remedies or packages of remedies which we consider would be equally effective, we will choose that which imposes the least cost or that is the least restrictive (*CC3*, paragraph 4.10).

11.9 We will also have regard to the effects of any remedial action on any relevant customer benefits within the meaning of section 134(8) of the Act arising from the adverse feature or features of the market concerned. Such benefits comprise lower prices, higher quality or greater choice of goods or services or greater innovation in relation to such goods and services. To qualify within the meaning of section 134(8), we must believe that the benefit would be unlikely to accrue without the relevant feature or features.

11.10 In general, we should seek to implement (or recommend) remedies that address the AEC, though we may also choose to address the detrimental effect on customers (*CC3*, paragraph 4.6).[1] In our guidelines, we say that it is unlikely that, having decided that there is an AEC, we will decide that there is no case for remedial action, at least before we have given attention to any relevant customer benefits that may accrue from the market features.

Highly concentrated local markets

11.11 Paragraphs 10.9 and 10.10 summarize our findings in relation to highly-concentrated local markets. The remedies set out in this section address strong local market positions where barriers to entry arise from *(a)* the planning system as it applies to grocery retailing (see paragraphs 11.12 to 11.135); *(b)* controlled landsites which act as a barrier to entry in a number of highly-concentrated local markets (see paragraphs 11.136 to 11.255). We also discuss in this section possible remedies in relation to multiple stores controlled by a retailer where it has a strong local market position (see paragraphs 11.256 to 11.268).

Planning and the competition test

Summary of remedy

11.12 To address the AEC that we found in relation to local market concentration, we decided to recommend the following measures in order to establish the competition test within the planning system:

[1]The CC has said (*CC3*, paragraph 4.22) that it 'will first look for a remedy that would be effective in dealing with the adverse effects on competition of the market features rather than seeking to deal with any detrimental effect on customers'.

(a) that CLG and the devolved administrations take such steps as are necessary for the OFT become a statutory consultee;

(b) that CLG and the devolved administrations take such steps as are necessary (including changes to the Town and Country Planning (General Development Procedure) Order (GDPO) and its equivalents and to planning policy) to ensure that the OFT is consulted by LPAs on all planning applications for grocery store developments (including new stores and extensions, whether submitted by large grocery retailers or third parties including other grocery retailers) where the developed store will be in excess of 1,000 sq metres net sales area;

(c) that CLG and the devolved administrations take such steps as are necessary (including changes to planning policy) to ensure that where LPAs give open A1 planning permission that is not to be used for grocery retail, planning conditions are applied that limit groceries floor space to less than 1,000 sq metres;

(d) that CLG and the devolved administrations take such steps as are necessary (including changes to the GDPO and its equivalents and to planning policy) to ensure that LPAs take account of the OFT's advice on the result of the competition test (see below) and that LPAs may only determine planning applications in a manner inconsistent with that advice where they are satisfied that:

(i) the particular development would produce identified benefits for the local area that would clearly outweigh the detriment to local people from the area becoming or remaining highly concentrated in terms of grocery retailing; and

(ii) the development, or any similar development, would not take place without the involvement of a large grocery retailer that had failed the competition test (see below);

(e) that CLG and the devolved administrations take such steps as are necessary (including changes to planning policy) to make clear that where LPAs determine planning applications in a manner inconsistent with the OFT's advice on the result of the competition test, they do so only when they have demonstrated on the basis of sound evidence that the criteria set out above have been satisfied and set out publicly the reasons for overriding the OFT's advice; and

(f) that CLG and the devolved administrations take such steps as are necessary (including changes to planning policy) to ensure that section 106 contributions in connection with matters unrelated to competition should not be considered by LPAs as sufficient to offset the effect the development would have on concentration in the local market.

11.13 We note that the introduction of the competition test into the planning system is contingent on action by CLG and the devolved administrations. We recommend to BERR that, if the competition test is not established within the planning system by CLG and the devolved administrations, it should take such steps as are necessary to implement the competition test outside the planning system.

11.14 In applying the competition test as part of the planning system, we recommend that the OFT provide advice on the result of the competition test to LPAs. In applying the competition test, we recommend that the OFT:

(a) assess concentration across an area defined using a 10-minute isochrone (calculated using a standard, readily available package such as MapInfo/Drivetime) around the store that is to be developed;

(b) count the number of fascias (including that of the retailer that might operate the developed store) operating large grocery retail stores within the isochrone, such fascias to include all full-range national or regional grocery retailers and symbol groups and independently-owned full-range grocery store operators;

(c) (where the number of such fascias is three or fewer) calculate the share of groceries floorspace within the isochrone that the grocery retailer operating the developed store would have after the development had been implemented, such calculation to include all full-range national or regional grocery retailers and symbol groups and independently-owned full-range grocery store operators;

(d) where a planning application was submitted by a large grocery retailer, provide advice to the LPA on whether that grocery retailer had passed or failed the test;

(e) where a planning application was submitted by a third party (including a grocery retailer that is not a large grocery retailer), provide advice to the LPA on which grocery retailers would fail the test;

(f) a particular retailer will pass the test for a particular local area (ie within a 10-minute isochrone around the store to be developed) if:

(i) it would operate the developed store as a new entrant in the local area;

(ii) the total number of fascias in the local area were four or more; or

(iii) the total number of fascias were three or fewer and the grocery retailer operating the developed store would have less than 60 per cent of groceries sales area in the local area (this decision taken on the basis of a majority of four to two);

(g) a particular retailer would fail the test if:

(i) the grocery retailer was not a new entrant in the local area;

(ii) the total number of fascias in the local area were three or fewer; and

(iii) the retailer would have 60 per cent or more of groceries sales area (including the new store) in the local area (this decision taken on the basis of a majority of four to two).

11.15 In order to ensure the effective working of the competition test remedy, we will require all grocery retailers to provide to the OFT on request accurate figures for the groceries sales area of any store in the UK, and any other information that the OFT may require for the application of the competition test.

11.16 As a complement to our competition test remedy, we will also require large grocery retailers to notify to the OFT all acquisitions of existing stores of more than 1,000 sq metres.

11.17 We recognize that the OFT will need to allocate its resources to fulfil these new functions.

The need for a competition test

Views of the parties

11.18 Most retailers[1] were in favour of the introduction of a competition test at some point in the process of store development, although views differed on the point at which it should be applied. Asda considered that a competition test would help to mitigate the effect of the planning regime on competition and choice. The ACS welcomed a competition test as one factor that should be considered in planning decisions. Morrisons also said that local factors should be able to influence decisions.

11.19 Tesco, on the other hand, was strongly opposed to a competition test. It did not think that we had identified an AEC that justified a competition test (which it referred to as a 'local growth cap'). Tesco also considered that a competition test would not address the feature of the market we had identified as giving rise to this AEC. Tesco said that a mechanistic competition test would:

- be anti-competitive and wrong in principle;
- lead to less investment and fewer stores in marginal areas where other retailers would not develop despite the existence of significant public policy benefits;
- add an additional layer of regulation and uncertainty to an important sector of the economy;
- possibly result in customers paying higher prices and getting a fascia they preferred less;
- be arbitrary and encourage strategic behaviour by retailers who would open sub-optimal stores to keep within thresholds or not to open new floorspace where doing so would allow a competitor to also expand;
- be unnecessary, disproportionate and give rise to perverse effects;
- severely affect retailers' strategies as the confidentiality of site assembly would be threatened;
- lead to many appeals and 'regulatory gridlock';
- limit LPAs' ability to approve developments which would benefit customers and communities such as regeneration schemes;
- have significant implications for landlords, developers and vendors of property outside the scope of our investigation; and
- reduce demand for sites, and developers might instead find non-grocery uses for sites more attractive.

11.20 Both Sainsbury's and Tesco suggested that there were some local areas that would, in practice, be able to support only one or two grocery stores. Tesco said that 70 per cent of its stores in the areas in which it held a strong local market position were in

[1]Asda, Sainsbury's, Morrisons, Waitrose, Somerfield, CGL and M&S.

areas where the local population tended to be fewer than 15,000 people.[1] Tesco told us that, on the basis of its reproduction of the first-stage regression of our margin concentration analysis, our analysis predicted that an increase of 34,052 people led to an increase of one extra store above 280 sq metres. From this, it told us that 34,000 more people within 10 minutes were required to support an additional store of 'above 280 sq metres'—so only expansions and replacement stores would be possible.

11.21 Two LPAs—Weymouth and Portland Borough Council and Alnwick District Council—said that LPAs did not select particular retailers for sites. Alnwick District Council said that planning focused on the appropriateness of the use of land, not its occupier, and therefore competition between grocery retailers was not a planning issue.

11.22 CLG told us that, separately from our investigation, it was increasing the emphasis on competition within the planning system in England. It pointed to its consultation document on PPS4 which made references to considering competition in the context of planning applications for sustainable economic development.[2] We discuss the planning framework more generally in Appendix 7.2. CLG noted that, in its view, the 'town centre first' policy, set out in PPS6,[3] helped to encourage competition among retailers since it ensured that retailers were situated in close proximity to each other, thereby making them more likely to compete. CLG said that it would shortly release a consultation document on PPS6 which, among other things, was likely to emphasize the importance of choice and diversity. CLG suggested that we should consider whether there was scope for competition considerations to be taken into account by LPAs considering the impact of a proposal, without requiring a formal competition test, by considering the extent to which a proposal promoted competition and consumer choice. In this context, however, CLG did not suggest that the specific identity of the fascia should be evaluated. CLG told us that the introduction of competition considerations aimed at addressing market share and complex competition matters within the planning system would represent a fundamental change to planning policy. It was its view that such considerations did not normally extend to the identity of the occupant. CLG clarified that the planning system had, to date, not easily enabled decision-makers to take into account the occupier of a building and that planning conditions on permissions restricting a building's occupancy were generally only possible in special circumstances.

11.23 The Scottish Government Planning Directorate, the Welsh Assembly Government Planning Division and the Northern Ireland Department of the Environment echoed many of the points made by CLG. Each noted that the planning system was concerned with land use and that any requirement to consider the identity of the user would run contrary to conventional planning considerations. The Welsh Assembly Government Planning Division also noted that planning authorities had no competition expertise. The Northern Ireland Department of the Environment, responsible for planning in Northern Ireland, expressed similar concerns over planning being concerned with the use of the land instead of the identity of the operator and the lack of competition expertise within the planning authority.

[1] Tesco said that 70 per cent were in areas which the Office for National Statistics classifies as 'Coastal and Countryside' or 'Prospering Small Towns'. Tesco told us that they tended to have fewer than 15,000 people in the town itself. We note, however, that the local market would be likely to extend beyond the town itself.
[2] Consultation Paper on a new Planning Policy Statement 4: Planning for Sustainable Economic Development, December 2007.
[3] Planning Policy Statement 6: Planning for Town Centres, 2005.

Our views

11.24 The current planning system, with its focus on the character and use of land, identifies whether there is an overall 'need' for a new development rather than the identity of a specific occupier.[1] This means that an LPA currently does not have the ability to consider the consequences of 'need' being met by a particular operator, according to how that particular operator may create or strengthen an area where it has a strong local market position. We discuss the 'need test' more specifically in our discussion of proposals to modify the planning system in paragraphs 11.126 to 11.135.

11.25 The town centre first policy may help to promote competition in so far as it results in grocery retailers being located in close proximity to each other. However, we note that the identity of the operator, which is a key criterion in assessing the extent of competition, is not taken into account in PPS6 in the town centre first policy. Nor is this proposed for England in the CLG consultation paper on PPS4. From our discussions with CLG and the planning directorates of the devolved administrations (see paragraphs 11.22 and 11.23) we do not consider that such a focus would evolve without our intervention. Even with the town centre first policy in place, for large grocery retailers with larger grocery stores we have identified 495 highly-concentrated local markets within a 10-minute drive-time and 209 stores within a 15-minute drive-time (paragraphs 6.14 to 6.19). We do not think that we can rely on this policy alone (despite the consultation paper on PPS4 and the likely amendments to PPS6) to prevent the emergence of such areas in the future or to encourage development that would increase competition in existing highly-concentrated local markets. In order to achieve this, it is our view that a specific focus on the identity of the operator is essential.

11.26 Overall, we find that a competition test is necessary to prevent the emergence or strengthening of a strong local market position held by a particular large grocery retailer in respect of larger stores in a local market. To the extent that this represents a 'cap on growth', we believe this to be necessary to prevent retailers' positions in local markets becoming unacceptably strong. In our view, the planning regime either as it currently exists or, in the case of England, if changed along the lines of current proposals would not be sufficient to prevent the emergence of highly-concentrated local markets or the strengthening of strong local market positions held by particular retailers. In particular, the identity of the retailer that will operate from the proposed grocery floorspace and the effect that this would have on the degree of concentration in a local market must be taken into account in determining whether to grant permission.

11.27 We see the competition test remedy as an important complement to our remedies in relation to controlled land and multiple stores (see paragraphs 11.136 to 11.268). While those remedies address barriers to entry in existing highly-concentrated local markets, the competition test will prevent the emergence of areas of highly-concentrated local markets or the strengthening of strong local market positions in the future.

11.28 We do not consider it sufficient to rely on the existing merger control regime to prevent the emergence or strengthening of highly-concentrated local markets since the merger control regime can apply only when a grocery retailer acquires a trading store from a competitor. However, it does not apply in situations where a grocery retailer acquires a store that has been closed for some time, or moves into a newly-

[1] See Appendix 7.2, paragraphs 2 to 4.

developed store. We note that the merger control regime has not been sufficient to prevent the emergence of highly-concentrated local markets to date.

11.29 We noted the relationship between the competition test and a competition assessment under the merger control regime. In our view, there are substantial differences between the two. A new store or an extension may strengthen an incumbent's position, but it also expands the provision of grocery retailing in the local area, which does not occur with a merger where existing stores change ownership. In our view, competition and choice are of critical importance to a well-functioning grocery market but, because a new store expands the provision of grocery retailing, we believe that the thresholds for intervention should be higher than in a merger inquiry. The interaction of the merger control regime with our remedies is discussed further in paragraphs 11.123 and 11.124, and Appendix 2.1.

11.30 We explored the point, raised by Tesco and Sainsbury's, of whether there were 'natural monopoly' areas, in which the application of a competition test may be inappropriate. We note that some areas with low population, which might be expected to be 'natural monopolies', have more than one store.[1] However, we accept that there may be areas where there are three or fewer fascias present and where the local population is too low to support entry by an additional fascia. It is important to note that our competition test would not have the effect of prohibiting all development by existing grocery retailers in the local area; rather it would prevent development that would lead to one grocery retailer having an unacceptably strong local market position or strengthening such a position.

11.31 We assessed Tesco's claim that, on the basis of its reproduction of the first-stage regression of our margin concentration analysis, our analysis predicts that an increase of 34,052 people leads to an increase of one extra store of above 280 sq metres. From this it told us that 34,000 more people within 10 minutes were required to support an additional store above 280 sq metres—so only expansions and replacement stores would be possible.

11.32 We agree that there is a general positive relationship between population and the number of stores in an area (see Annex 1 of Appendix 7.1). The first-stage regression results of our margin concentration analysis also clearly show this positive relationship. However, the purpose of this regression is not to identify the exact relationship between the size of the population and the number of competitors and we do not think that these results show that 34,000 more people are required to support an additional store above 280 sq metres.

11.33 We also assessed Tesco's comment that a competition test could have significant negative implications for developers. This argument is based on a number of assumptions. First, it assumes that a grocery retailer that would fail the competition test would also be the highest bidder among grocery retailers. This suggests that a grocery retailer with a strong local market position would bid more because there is value to the retailer in maintaining that position by preventing competitor entry. The competition test seeks to prevent that extra value being transferred from the consumer to the retailer. Secondly, it assumes that, in the absence of a particular retailer bidding, other grocery retailers would bid less than bidders for non-grocery uses. We do not see why this should be the case. Therefore, we do not agree that the

[1] One of the most extreme cases is Huntly, which has a population of around 5,000 in the town itself (and around 16,000 within a 20-minute drive-time), and two large grocery stores—an Asda and a Tesco—in the town. We also provide a number of other case studies in Annex 1 of Appendix 7.1.

exclusion of any particular grocery retailer would necessarily result in a site being used for other, non-grocery uses.[1]

11.34 We note the concern expressed by Tesco that the competition test would mean that retailers would be unable to assemble sites confidentially. However, we consider that the application of the competition test would not lead to any greater confidentiality concerns than is the case under the current planning system. No information would need to be made public before the planning application was submitted. We accept that the competition test would mean that a grocery retailer submitting a planning application would need to disclose its identity as part of the planning application, in order that the OFT might apply the test.

11.35 We remain of the view that a competition test is an appropriate tool for preventing the emergence of highly-concentrated local markets and the strengthening of strong local market positions in the future. We take the view that the other points raised by the retailers in opposition to the competition test (for example, in relation to the effect on investment, strategic behaviour, regulatory burden, uncertainty, perverse effects and regulatory 'gridlock') are best dealt with in the design of the test, which is discussed below.

The framework of the competition test

11.36 In the Remedies Notice we consulted on the following issues:

(a) whether the competition test should be within or outside the planning system;

(b) the role of the competition test within the development plan; and

(c) the substance of the competition test.

We discuss each in turn below.

The competition test within or outside the planning system

11.37 The competition test could operate within or outside the planning system. If outside the planning system it could be applied before, after or in parallel with the planning application. Grocery retailers could be required to pass the test before beginning to trade from a particular location (or from an extension to an existing location). If the test were to operate within the planning system, it could be applied either by the LPA itself or by a statutory consultee such as the OFT, the outcome being a factor to be taken into account by the LPA in determining the planning application. A related issue is the weight that the LPA would be expected to attach to the advice of the OFT, and how the advice would affect the LPA's decision.

- *Views of the parties*

11.38 Those retailers who responded to our Provisional Decision on remedies were generally against a competition test operating outside the planning system.[2] The ACS said that competition should be considered within the planning system, but should be only one consideration of the planning authorities.

[1] Of course, the developer may receive lower bids because, with the competition test, the bids would not reflect the value of maintaining a concentrated position.
[2] M&S considered that the competition test could also be made to work outside the planning system, however, and was concerned at what it perceived as the negative views of CLG about having the test in the planning system. Asda noted that there was merit in having the competition test outside the planning system.

11.39 Retailers were divided over whether, if the competition test were to be part of the planning system, it should be applied by the LPA or by the OFT as statutory consultee. Asda, M&S, Aldi, Tesco[1] and the ACS all said that the competition test should be applied by the LPA. Tesco and the ACS said that making the OFT a statutory consultee would effectively make the OFT the decision-maker for the planning application. Sainsbury's, Morrisons and Somerfield, on the other hand, said that the test should be applied by the OFT as statutory consultee. Waitrose said that the LPA should only approve an application that the OFT had said failed the competition test in exceptional circumstances. M&S said that additional weight should be given to OFT advice by placing a requirement on LPAs to notify the OFT and CLG of any decision to grant planning permission against the advice received.

11.40 Morrisons said that the OFT should have the power to have the application 'called in' if the LPA sought to approve planning permission against its advice. M&S said that the GDPO could be amended to give the OFT the opportunity to ask the Secretary of State to call in a planning application and hold a public inquiry where a decision was taken by the LPA to grant planning approval in cases where the OFT had advised that an application failed the competition test. Friends of the Earth felt that the GDPO could be used to allow the OFT to prevent the LPA from determining a planning application for an indefinite period while the OFT assessed the competition impact.

11.41 The retailers that considered it was appropriate for the OFT to act as statutory consultee also said that the OFT should take part, if necessary, in planning appeals.

11.42 Both Weymouth and Portland Borough Council and Alnwick District Council, on the other hand, suggested that the test should be outside the planning system and said that it should be administered by the OFT. CLG and the planning directorates of the devolved administrations said that there would be a number of difficulties associated with having the competition test within the planning system. In particular, all the administrations recognized that the planning system was only concerned with the use of the land and not the identity of the user, and that changing the planning system to reflect this would be a significant change to planning policy.

11.43 CLG expressed caution about the principle of including a competition test as part of the planning process, since it would involve consideration of market share and what it saw as complex competition issues. Furthermore, it would represent a significant departure from the normal planning process, which is predominantly concerned with the use of land rather than the identity of the occupier. This was thought to have wider ramifications for the planning system.

11.44 The CLG and the planning directorates of the devolved administrations said that LPAs were capable of applying a competition test, although they would need clear guidance and assistance from the OFT as an advisory body. CLG said that, alternatively, the OFT could be made a statutory consultee by amending the GDPO, which provides for statutory consultees to be consulted by LPAs. CLG said that, if this amendment were made, the LPA would need to take account of the OFT's advice as a statutory consultee, although the LPA would need to weigh up any competition concerns alongside other issues when deciding a planning application. CLG and the planning directorates of the devolved administrations felt that the changes required to introduce the competition test could be accomplished through changes to government policy instead of changes to legislation. CLG recognized the need to ensure that its consultation on a revision to PPS6 took account of any recommendation to introduce a competition test.

[1]Tesco suggested a more flexible approach in which competition was one of a list of factors to which LPAs had regard, and which would include matters such as regeneration, economic development and social inclusion, would be more appropriate.

11.45 CLG suggested that the application of the competition test should not necessarily have to result in a 'pass' or 'fail' but could allow the OFT flexibility to advise on an application in such a way that signalled the extent of its concerns (for example, indicating whether it considered that the application should not be granted in any circumstances, or whether the concerns might be outweighed by other factors). However, on the basis of experience from other areas of planning policy such as Green Belt policy, CLG recommended that we should set out clearly the circumstances under which an LPA would be justified in overriding advice from the OFT in relation to the competition test (along the lines of the guidance provided in PPG2).

11.46 The OFT expressed various concerns at the prospect of being required to apply a competition test. The OFT felt that, as a specialist competition body, if it administered the test it would be expected to perform a sophisticated assessment (taking into account all potentially relevant substantive competition aspects, and thus more sophisticated than the test than we envisage) and that the application of the test could be read across to merger control decisions in the grocery retail sector and the OFT's investigations in other retail sectors. It felt that, with suitable OFT guidance, and especially if the competition test were based along clear bright lines, the LPAs would be better placed to administer the test and weigh the test against other features of the proposal.

- *Our views*

  - ♦ *A test within or outside the planning system*

11.47 We recognize that there would be benefits in having a competition test that sits outside the planning system. Implementation would be simpler because there would be no need to amend the planning system of each of the devolved administrations separately. It would also ensure a consistent outcome because the passing or failing of the test would be decisive to a retailer's ability to develop a store, whereas in the planning system the outcome would not necessarily be determinative of the planning application as the decision would ultimately rest with the LPA.

11.48 In our view, however, there would also be disadvantages in the test sitting outside the planning system. It would remove from the LPAs any ability to weigh the competition effects of a development against other factors. Although we consider them to be exceptional, we acknowledge that there may be circumstances which justify the permission being granted despite the competition test having been failed. We discuss the nature of these exceptional circumstances below (see paragraphs 11.53 to 11.56). An advantage of the test sitting within the planning system is that it would allow LPAs to retain such discretion, and would therefore more easily be consistent with the wider public policy objectives of the planning system. In addition, a test within the planning system would make use of an existing regulatory process, which should lead to lower implementation costs than those associated with an entirely new process.

11.49 We conclude that the competition test could operate effectively either within or outside the planning system. We recognize that, as discussed in paragraph 11.47 et seq, there are advantages in including the test within the planning regime. We also believe that there are advantages in allowing LPAs to balance competition issues against other planning issues in exceptional circumstances, as specified in paragraph 11.53. We therefore decided to recommend that CLG and the devolved administrations take such steps as are required to introduce a competition test within the planning system. The details of this test are discussed below.

♦ *A test applied by the OFT or by the LPA*

11.50 We noted the concerns raised by the OFT in relation to the application by it of the competition test. However, we note that the OFT has applied mechanistic tests previously (for example, rules for the evaluation of store divestments following the Safeway inquiry in 2000). We also consider that, as an expert competition authority, the OFT would be better placed to apply the test in a consistent manner than each LPA. This is especially the case since for some LPAs applications subject to the competition test may be infrequent, so that the LPAs would need to reacquaint themselves each time with the test. We also believe that the competition test is capable of being clearly ring-fenced both within the OFT (perhaps in a similar way to other remedies monitoring work) and within the planning system. We therefore do not think that the competition test would affect the OFT's exercise of its other functions or other retail sectors not subject to this investigation.

11.51 We recognize that the application of the competition test, and in particular the need to consider the identity of the user of land, differs from the usual approach to planning and would involve potentially significant cultural change within LPAs. Taking into account these factors and the benefits of consistency from having one authority applying the test we decided that, overall, the OFT would be the most appropriate body to apply the competition test.

11.52 We note that the GDPO and similar arrangements in the devolved administrations[1] (which legislation we refer to collectively as the GDPO) requires an LPA to consult with a number of statutory authorities and other regulatory bodies prior to granting planning permission for specified types of development. The LPAs are required to take into account the views of such consultees, but are not bound by their views. In our view, this existing framework provides a useful way in which the OFT can apply the competition test. We therefore recommend that CLG and the devolved administrations promote the changes to the GDPO and relevant guidance documents to establish the OFT as a statutory consultee in relation to planning applications for grocery stores that would, after the development, have a net sales area in excess of 1,000 sq metres. LPAs should ensure that their decisions on planning applications for larger grocery store developments are in line with the OFT's advice save in exceptional circumstances (see paragraph 11.53).

♦ *Circumstances in which LPAs should be able to override the OFT's advice*

11.53 In our view, the circumstances under which an LPA would be able to justify a planning decision in which it overrode the OFT's advice on the result of the competition test should be truly exceptional. Specifically, we consider that LPAs should be able to decide in favour of a planning application in a manner inconsistent with the OFT's advice only if the LPA is satisfied that:

- the particular development would produce identified benefits for the local area that would clearly outweigh the detriment to local people from the area becoming or remaining highly concentrated in terms of grocery retailing; and

- the development, or any similar development, would not take place without the involvement of a large grocery retailer that had failed the competition test.

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[1]In Scotland, the legislation is the Town and Country Planning (General Development Procedure) (Scotland) Order 1992, and in Wales the legislation is The Town and Country Planning (General Development Procedure) Order 1995. The Northern Ireland Department of the Environment told us that statutory consultees could be established there via service level agreements, although if a legislative route were preferred Article 20(2) of the Planning (NI) Order 1991 refers.

11.54 We believe it is important that an LPA should be able to determine a planning application in a manner inconsistent with the OFT's advice only when it has demonstrated on the basis of clear and sound evidence that both of the criteria set out above have been satisfied. It is important that where an LPA takes such a decision, it must set out publicly its reasons for overriding the OFT's advice and must make clear the evidence on which it has done so.[1] In particular, where a local authority is instrumental in bringing forward the development, whether through ownership of the land or otherwise (for example, as part of a regeneration scheme) there must be a convincing case why another retailer, or retailer/developer partnership, would not be prepared to take on the project. This could be demonstrated through market testing to make sure that there are no alternative retailers or retailer/developer partnerships that would take on the scheme.

11.55 Section 106 or section 278 contributions in connection with matters unrelated to competition should not be considered by LPAs as sufficient to offset the effect the development would have on concentration in the local market. However, we note that it would be possible for LPAs to use section 106 agreements to impose an obligation on a retailer to cease to trade from a store from which it has said it will cease to trade as part of a resiting operation should the retailer fail the competition test if the existing store remained open. In such circumstances the LPA may wish to give consent that would allow the use of a site by a retailer that the OFT has advised fails the competition test.[2]

11.56 We recommend that CLG and the planning directorates of the devolved administrations should issue guidance in line with our final report, indicating the weight that the LPA should attach to the OFT's advice on the competition test and the exceptional circumstances in which it may override that advice as set out here.

- *Directions and 'call-ins'*

11.57 It would be possible for the OFT, as a statutory consultee, to be given powers to direct the LPA to refuse a planning application on competition grounds if it failed the competition test. The Highways Agency, for example, acting on the Secretary of State's behalf, is occasionally obliged to restrict the grant of planning permission because there is no practicable remedy to the traffic consequences of a development. The Mayor of London also has powers to direct LPAs to refuse specified categories of development in Greater London.[3] However, we noted the exceptional nature of these arrangements. We also noted the advantages we see in LPAs having the ability to decide, in exceptional circumstances, to override the OFT's advice. We therefore decided that it would not be appropriate to recommend that the OFT should be given specific powers to direct LPAs to refuse planning applications on competition grounds.

11.58 As discussed above, we are keen that the LPAs take the OFT's advice on the application of the competition test very seriously and we therefore gave thought to whether, if an LPA overrode the OFT's advice, its decision should be subject to call-in. However, we note that such a move would be contrary to the general direction of planning policy, which is seeking to reduce the extent of ministerial involvement in

[1]We note that this would require a change to the GDPO in England, and its equivalent in the devolved administrations, since an LPA does not usually have to set out its reasons determining an application in a manner inconsistent with a statutory consultee's advice.
[2]This is line with our approach to resiting of stores, where an application may pass the competition test because a section 106 agreement or planning condition is already in place that will ensure the closure of the old store—see paragraph 11.55.
[3]Through section 74 of the Town and Country Planning Act 1990, as amended by section 344(9) of the Greater London Authority Act 1999 and implemented by means of the Town and Country Planning (Mayor of London) Order 2000 which gives the Mayor certain powers to direct an LPA to refuse planning applications for specified categories of development in Greater London.

planning decisions. Furthermore, such powers would add to the cost associated with the competition test remedy, including the burden placed upon the OFT in supporting any call-in or appeal. We therefore decided not to recommend that the OFT be given powers to ask the Secretary of State to call in or delay a planning application.

- *'Fallback' position—a competition test outside the planning system*

11.59 We recognize that the introduction of the competition test within the planning system, in line with our recommendations set out above, requires action on the part of CLG and the devolved administrations. We therefore believe it is necessary to make a recommendation to BERR that, if the competition test is not established within the planning system by CLG and the devolved administrations, it should consider taking steps to introduce the competition test outside the planning system.

The role of the competition test within the development plan

11.60 Planning applications are determined in the context of the development plan. We considered whether and how competition issues should be taken into account in the development plan-making process.

- *Views of the parties*

11.61 Asda said that there should be two forms of the competition test. In the first, LPAs would identify areas where competition was inadequate and take steps to promote new entry, for example by identifying sites for new entry, as part of the development plan process. The second would involve the application of a specific competition test to particular planning applications, preventing store openings that give rise to a high degree of concentration in a local market. Tesco disagreed with both aspects of the Asda proposal, reiterating its view that the competition test amounted to a 'growth cap'. Other retailers envisaged only the second competition test, which would operate at the development control stage in respect of submitted planning applications (Sainsbury's, Morrisons, Waitrose, M&S).

11.62 Tesco considered that the issue of when to require retailers to apply for a competition 'consent' gave rise to substantial difficulties, whether before or after planning. It stressed that a competition test applied at any stage would be a significant deterrent to site assembly. If retailers had to apply for competition approval for the first parcel of land acquired and permission were refused, retailers would not continue with the process of site assembly. If the licence were awarded and became public knowledge, the rest of the site assembly would become more difficult and expensive. Tesco was also concerned that investments that were authorized under a competition test could be jeopardized by changing competitive circumstances.

11.63 CLG and the Scottish Government Planning Directorate said that planning law required that decisions were made in accordance with the development plan unless material considerations indicate otherwise. However, policy could be changed such that failure of the competition test would be recognized as a material consideration. CLG said that the introduction of a competition test for planning applications would need to align properly with the development plan system. CLG did not wish to see the inclusion of a blanket requirement for development plans to have a policy reference to a competition test in the development plan as this would serve little purpose. On the other hand, CLG believed it would be possible for LPAs to identify whether there were areas of high concentration within their local planning areas. If the LPA identified such areas and there was an established need for more floorspace, it could then identify sites that could be used for grocery retailing so as to ameliorate the effects of that high concentration. Should a grocery retailer then wish to develop any of those sites, that retailer would be subject to the competition test.

- *Our views*

11.64 A general competition test might be included as part of the development plan process, identifying, for example, any areas of high concentration in grocery retailing and possible sites for additional grocery retail use with a view to promoting competition. However, we thought that, in order to be useful, this process would need to identify specific retailers whose entry or expansion would promote competition in the area. Given that plans are developed over several years and remain in force over several years, such identifications might become outdated so that at the development plan stage, a competition test could do more than provide limited guidance as to permitted future developments and would not in itself be an adequate remedy. Because of its limitations we saw no justification for recommending this as part of the remedy.

11.65 Overall we concluded that the competition test should be applied only at the development control stage, that is, in connection with an individual planning application. We also recommend that planning policy, both for central Government and for the devolved administrations, be changed so as to set out the policy basis on which the competition test and the result in any given case becomes a material consideration.[1]

Substance of the competition test

- *Views of the parties*

11.66 Asda, Morrisons and Waitrose all suggested that the competition test should be based on fascia only, with no assessment of market shares, and should prevent retailers opening new stores where there are fewer than four fascias present in an area.

11.67 Sainsbury's, CGL, M&S, Somerfield and Aldi suggested that the competition test should be based on local market shares. Several parties commented on the market share threshold above which a grocery retailer should fail the competition test. Asda suggested that, if we were to introduce a share of floorspace test, a level of 50 per cent would be appropriate. The ACS suggested that a share of over 40 per cent should be subject to scrutiny under the test, with a share above 60 per cent definitely failing the test. CGL also suggested the use of a variable market share with discretion exercisable for market shares between 50 and 60 per cent. M&S suggested that the share above which a development would fail the test should be between 40 and 50 per cent.

11.68 Sainsbury's proposed that the local market share threshold above which a grocery retailer should not be able to operate from a new development should be more stringent for a retailer with national market power. Sainsbury's said that Tesco's share of national sales, and its purchasing cost advantage, often combined with high local market share, meant that it could afford to bid more for new space than its competitors. It also said that Tesco had a greater incentive and ability than its competitors to deter entry by creating a reputation for aggressive response. Sainsbury's suggested that, for example, the threshold applied to retailers without national market power could be a 50 per cent market share within the isochrone, but

[1]We understand that changes to legislation would not be required for the competition test to be recognized as a material consideration.

that this should be reduced to 40 per cent for a retailer with national market power. Sainsbury's also proposed that the market share threshold should be based on the retailer's average revenue per sq metre rather than on its local sales area.

11.69 Tesco believed that any test would have substantial design problems. Tesco said that the number of fascias in a fascia-count and the market share threshold would be arbitrary and that the fascias that would be to be taken into account in the test were too limited. Tesco also said that a competition test should not capture extensions and replacements since they brought improvements to consumers.

11.70 Retailers also commented on whether the thresholds for inclusion in the test and for the measurement of floorspace market shares should be based on net sales area or groceries sales area. CGL, Morrisons, Tesco and Waitrose[1] suggested that there would be significant problems with a test based on groceries sales area, which would be difficult to measure and subject to 'gaming'. Asda[2] was concerned that retailers might not be able to replicate the market share calculation since data on groceries sales area was not publicly available, and Tesco felt that having to rely on estimates of groceries sales area would create uncertainty for businesses looking to invest. M&S, on the other hand, favoured a measurement based on net groceries sales area.

11.71 Asda, Morrisons and Waitrose said that stores and developments above 1,400 sq metres net sales area should be included in the competition test.[3] Sainsbury's said that a market share test should be based on a 15-minute drive-time isochrone centred on the development site for all proposals where the additional floorspace was over 1,000 sq metres.[4] However, the ACS, Friends of the Earth, CGL and M&S said that the size threshold should be lower than 1,000 sq metres. The ACS felt that where a retailer failed the test, the restriction on development should apply to all additional grocery floorspace irrespective of the size of the store proposed.

11.72 Sainsbury's said that the assessment should not apply to extensions or on-site replacements (Sainsbury's believed that these did not act to the same extent as a barrier to entry and submitted produced by the economic consultancy RBB Economics to support its views). Sainsbury's said that, in general, compared with new stores:

- extensions tended to have a lower proportion of floorspace dedicated to groceries rather than non-groceries;
- on average, floorspace in extensions traded less intensively;
- a retailer would not have the same opportunity to degrade its offer as a result of an extension;
- a new store resulted in a worse outcome for consumers because a retailer had the opportunity to degrade its offer at the old store in favour of the new store, in a way that an extension would not;

[1]Waitrose, Morrisons and Asda felt that the competition test should not include a market share criterion.
[2]Asda suggested that gaming would be unlikely because a retailer could not reallocate floorspace without worsening its retail offer. Asda suggested that the OFT should publish actual grocery sales area data, based on data submitted by retailers, and said that it collected data on floorspace space allocation as part of its routine performance management because of the importance of assessing space utilization and expected its rivals to do likewise.
[3]Asda also suggested that the cut-off could be 1,000 sq metres with discretion being exercised to determine whether stores in this size range operated as large grocery stores or mid-range stores.
[4]Sainsbury's suggested that MapInfo isochrones (a commercially available mapping package that could be used to derive drive-time isochrones) should be used as the basis for assessing market shares.

- land used for an extension would be unlikely to be available for another retailer to use for a store because of its proximity to the original store. An extension therefore represented an efficient use of the land; and

- if extensions were included, it should only be where the incremental groceries sales area was over 1,000 sq metres.

11.73 Morrisons suggested that the application of the competition test to extensions and mezzanines should include a *de minimis* allowance, so that small internal space changes, such as movement of cafes or storage, would not be subject to the test.[1]

11.74 Asda suggested that store rebuilds should be subject to the competition test only if they resulted in an increase in groceries sales area.[2]

11.75 Sainsbury's commented on two ways in which it thought the competition test might be avoided by a grocery retailer. First, a store could be closed and then reopened as a new entrant. Second, a new store could be opened as a stand-alone non-groceries store adjacent to a groceries store without the competition test being applied.

11.76 The retailers that commented on this point proposed that the competition test should apply to all grocery retailers in the larger grocery store market.[3]

11.77 Asda, Sainsbury's and Somerfield said that it would be necessary to exercise some form of control over the ultimate beneficiary of planning permission granted to a developer.

- *Our views*

  ♦ *Which applications should be subject to the test?*

11.78 The objective of the competition test is to prevent the emergence of highly-concentrated local markets in the future and to prevent the strengthening of strong local market positions held by retailers in existing highly-concentrated local markets. We do not wish to impede the development of new or existing stores where overall they are of benefit, and our aim is not to create a situation in which every local market has a certain number of competing fascias. In particular, we do not wish to prevent new entry into an area but rather we seek to encourage it.

11.79 Taking into account our market definition, a planning application should be subject to the competition test if it is for a new grocery store over 1,000 sq metres or for development of an existing one (either through extension or construction of a mezzanine) that would result, if approved, in the store having over 1,000 sq metres.[4] We note that such applications may be submitted by a large grocery retailer, with a view to operate from the grocery store itself, or by a third party such a developer. It is important to note that we include grocery retailers that are not large grocery retailers in our definition of 'third parties'. Any application for a change in a planning condition that limited groceries sales area that would increase groceries sales area to a level in excess of 1,000 sq metres for an existing grocery store should also be subject to the competition test.

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[1]5 per cent of net sales area in any three-year period.
[2]Where a store is rebuilt, either on the same site or a different site nearby.
[3]Asda pointed out that the stores operated by the LADs, Iceland and Farmfoods, should be excluded as these fascias are not defined as being in the same market.
[4]In paragraph 11.110 we explain the area measure to be used for including a development in the competition test should be net sales area.

11.80 For the purpose of determining which applications should be subject to the competition test, a 'grocery store' should be any retail store, a significant proportion of which is devoted to the sale of groceries. We have in mind that this should include department stores with food halls but should exclude stores such as WH Smith and Boots, which have relatively small proportions of floorspace devoted to items such as sandwiches, confectionery and soft drinks. For the purpose of determining what constitutes a grocery store, 'groceries' should be defined in line with our terms of reference, ie food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods; and excluding: petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers, magazines, greetings cards, CDs, DVDs, videos and audio tapes, toys, plants, flowers, perfumes, cosmetics, electrical appliances, kitchen hardware, gardening equipment, books, tobacco and tobacco products.[1]

11.81 In this market investigation, we defined the market for larger grocery stores to include all stores larger than 1,000 to 2,000 sq metres (see paragraph 4.135). We therefore decided that the threshold for the application of the competition test should be 1,000 sq metres to encompass all stores that are—or after development will be—in the larger grocery store market. We consider that the incentive to 'game' the test will be limited to some extent because retailers have preferred store formats, from which they may be unwilling to deviate. Moreover, given that our concern in relation to highly-concentrated local markets was primarily with stores of around 1,400 sq metres in size, we consider that a limit of 1,000 sq metres should limit the impact of such behaviour on the effectiveness of our remedy.

11.82 The competition test should apply to all applications for developments that would result in grocery stores in excess of 1,000 sq metres. We note that this may mean that the competition test will be applied to developments proposed by grocery retailers that fall outside the category of large grocery retailers, as set out in our market definition (such as LADs). We believe it is important that these applications should be subject to the competition test. This is because, if applications were only subject to the competition test where it was envisaged that a large grocery retailer would operate the developed store, planning permission could be granted without the competition test having been applied on the basis that the store would not be operated by a large grocery retailer only for that store to be operated by a large grocery retailer who would have failed the competition test had it been applied.[2] This is particularly important given that, with a competition test within the planning system, once planning permission has been granted there is no possibility to apply the competition test. However, given that the test will assess the concentration of large grocery retailers operating larger grocery stores in the area, the application of the test will not result in another (not large) grocery retailer being prohibited from operating the store.

11.83 We also note that there is a possibility that a third party could apply for and receive open A1 planning permission for a non-grocery retail development which could then be occupied by a grocery retailer, thereby bypassing the competition test.[3] If an LPA intended to grant open A1 planning permission for a development that is not to be

[1]This definition of groceries ensures that the competition test is focused on grocery stores defined in line with our terms of reference. It is important to note that this definition of groceries is different from the one to be used by the OFT in the market share assessment (where it is important to have a definition that allows grocery floorspace to be measured—see paragraph 11.115).

[2]For example, if an LAD gains planning permission for a store and then agrees to a large grocery retailer acquiring the site.

[3]This is only likely to be possible for a town-centre development because otherwise it would also be a means of bypassing the need test.

used for grocery retail, we would anticipate a planning condition being applied that limited grocery retail space in the development to less then 1,000 sq metres.[1]

11.84 We note the arguments made by Sainsbury's that extensions should not be subject to a competition test. However, in our view, a retailer could use an extension to absorb consumer demand, thereby making it less attractive for new entry to occur and reinforcing its own position. We therefore decided that the competition test should be applied to an extension in the same way as to any other development. This should include an extension of any size to a store that already was, or when extended would be, in excess of 1,000 sq metres.

11.85 As a means of addressing possible avoidance, we consider that the competition test should apply to any development of a store within 100 metres of an existing grocery store owned or controlled by the same grocery retailer, in the same way as it would apply to an extension of that store.

11.86 We considered the application of the competition test to the rebuilding and replacement of stores. In the former case, a new store replaces an old store on the same site. In the latter case, a new store on a new site replaces an old store on a different site. The test should apply to both these cases. In either case, the competition test would need to take into account the proposed groceries sales area of the proposed new store. In the case of a rebuild, the groceries sales area of the old store would not be included in the calculation of the market share. However, in the case of a replacement, because of the uncertainty over the future of the old store, the groceries sales area of both would be taken into account. However, as noted below, if a retailer fails the test, the OFT is able to state the basis on which it would pass, for example, if the old store were to be closed (which could be secured by a section 106 agreement).

11.87 We note Morrison's suggestion that we should adopt a *de minimis* threshold, so that extensions below a certain size would not be subject to the test. We recognize that, if bigger extensions are more likely to have an effect in terms of creating or strengthening areas of high concentration, a *de minimis* threshold could help to focus the test on those applications more likely to affect competition. However, we are concerned that a *de minimis* threshold would provide grocery retailers with the ability to circumvent the test by extending their stores in successive small increments.

11.88 To address this concern, we explored the possibility of a 'one-off' *de minimis* threshold, which would allow a grocery store to enjoy one extension below a specified (and relatively small) size, while ensuring that all subsequent extensions were subject to the competition test. However, we did not think that such an approach would be practicable. We were concerned that records may not be kept adequately so that the LPA would know with certainty that a store had used its one-off *de minimis* extension, which may have taken place some years previously. We were particularly concerned about whether adequate records would be kept if the store changed ownership over time. Indeed, such a *de minimis* threshold may create a situation in which a grocery retailer or third party, not knowing that the *de minimis* extension had already been used, brought forward a scheme in the expectation of not being subject to the competition test, only to find that the test applied. For these reasons we decided that the competition test should include no *de minimis* threshold.

[1]We note that questions could be included in the proposed standard planning application form which would assist the LPA in determining which applications would be referred to the OFT to apply the competition test.

♦ *The area across which concentration is assessed*

11.89 The competition test provides an assessment of concentration in a local market, on the basis of which a decision may be taken about whether a particular development, operated by a particular grocery retailer, would lead to the emergence of a highly-concentrated local market or the strengthening of a strong local market position. It is therefore important to define the area across which concentration is to be assessed in the test.

11.90 The area across which concentration is to be assessed should be based on drive-time isochrones and centred on the site of the proposed new store. For consistency and clarity, a standard, readily-available package should be used to derive the isochrones. We understand that MapInfo/Drivetime is used by the OFT and a number of retailers to assess drive-times. This may well be a suitable package for the purposes of the competition test.[1]

11.91 We also thought about what drive-times should be used to calculate the isochrone. In our analysis of highly-concentrated local areas, we applied a drive-time of between 10 and 15 minutes. We thought about whether the same approach should be used in the competition test but were concerned that if we did not specify precisely the drive-time to be used, this would reduce the extent to which the retailers could predict the result and would introduce complexity. We therefore decided that a single drive-time should be used in the competition test for all areas. Overall, especially given that a 60 per cent market share threshold was in itself relatively high, we considered that setting drive-times at 10 minutes would be appropriate.

♦ *The fascia count*

11.92 In our view, a fascia count constitutes a useful first limb of the competition test. The number of fascias is an important measure of choice. Each of the large grocery retailers invests significantly in its brand and in the differentiation of its offer. A fascia test explicitly recognizes these activities which, for the consumer, translate into a wider choice of products and pricing than would otherwise be available. Where many large grocery retailers are present by virtue of their having grocery stores in excess of 1,000 sq metres in a local market, we believe that it is sufficiently unlikely that any store development would lead to the emergence or strengthening of a highly concentrated local market that it is not necessary to consider market shares.

11.93 Based on our experience in analysing local markets (see Section 7), we are confident that where there are four large grocery retail fascias with grocery stores in excess of 1,000 sq metres in a local area, the area is unlikely to be or to become highly concentrated. We therefore decided that all applications that relate to grocery store developments in areas where there are four or more fascias operating grocery stores in excess of 1,000 sq metres should pass the competition test regardless of the size of the proposed development or the market share of the applicant retailer whether before or after the opening of the proposed development. We recognize that there are areas where three fascias operate grocery stores in excess of 1,000 sq metres, which are not highly concentrated, but we note that a large grocery retailer would only fail the competition test in areas where there were three or fewer fascias and where that retailer had a market share in excess of 60 per cent.

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[1]We understand from the OFT that the current version of the MapInfo package (together with associated drive-time and other data packages) is MapInfo 9.0.1 and Drivetime 7.0. The data products that the OFT currently uses with MapInfo are GBPro200, Markermap (for postcode data) and OSNI AdminMap and Midimap for Northern Ireland. Drive-times are calculated using MapInfo's Streetline Drivetime data.

11.94 While a test based on a fascia count would be simpler to operate, it would not take account of the differences between large and small stores. Neither would it take account of increases in concentration as a result of development of extensions or mezzanines. We therefore decided that the competition test should incorporate not only a count of large grocery retail fascias with stores over 1,000 sq metres within the isochrone, but also a measure of market share within the isochrone. Store developments in areas where there are three or fewer large grocery retail fascias will be subject to a market share test.

11.95 We also gave thought to which fascias and stores should be taken into account in the assessing concentration under the competition test. Again, in line with our market definition, we consider that the test should take account of all stores in the isochrone that are in excess of 1,000 sq metres and operated by any of the full-range national or regional grocery retailers and symbol groups,[1] both for the fascia count and the market share assessment (see paragraph 11.79). Independently-owned full-range grocery stores above the 1,000 sq metre threshold should be taken into account both in the fascia count and the market share assessment. However, any such sized store operated by the LADs, Iceland and Farmfoods, which sell a limited range of products (see paragraph 3.3), would not be taken into account in applying the test.

11.96 At the time of applying the competition test, there may be a number of other developments in prospect. Account should be taken of such developments in the fascia count only if planning permission has been granted.

- *The market share assessment*

11.97 In our view, the competition test should broadly reflect the same principles that we applied to our analysis of highly-concentrated local markets and controlled land (see Section 7). The objectives of the two are, however, different. The competition test is essentially forward looking, whereas our analysis of controlled land sought to identify existing barriers to entry in areas of high concentration.

11.98 In our controlled land analysis, we used three means of identifying stores in highly-concentrated local markets which might have controlled landsites that are a barrier to entry (see paragraph 7.99). These included the identification of monopoly and duopoly areas as well as the identification of areas where a single retailer enjoyed a market share in excess of 40 per cent (see paragraph 7.100). When considering market shares, we set the market share above which we would examine an area more closely at a relatively low level so that we could be confident in identifying areas with potential competition problems. However, in our view, 40 per cent market was too low a level to be used as the threshold above which a retailer would fail the competition test.

11.99 In our view, when designing a remedy that will have the effect of limiting store development, we should be more cautious than when designing remedies that will remove barriers to entry and hence promote additional output or capacity and so take a more conservative approach in setting the market share threshold of our competition test.

11.100 In our Provisional Decision, we proposed a market share threshold of 60 per cent threshold, above which a retailer would fail the competition test. A number of retailers commented that this threshold was too high with M&S, CGL, ACS and Asda

[1]As above, we note that there may be new entrants into the grocery retail sector, or company strategies may change, that would mean that the OFT would periodically need to decide whether particular retailers should be included in the competition test, for example as may be the case if an LAD expanded its range.

suggesting various figures or ranges between 40 and 60 per cent. We reflected further on the market share threshold in the light of these comments. We think that a level of 50 per cent has merit and we are sympathetic to the arguments that a single retailer with a 50 per cent market share in a local area is likely to enjoy a strong position.

11.101 Two of us (Ms Almond and Professor Gregory) were of the view that our competition test remedy should go further than that outlined in our Provisional Decision, and prevent such concentration occurring in the future by adopting a maximum of 50 per cent for the threshold.

11.102 However, four of us identified a number of concerns with a 50 per cent threshold. We were concerned that such a threshold could effectively prohibit development in some local markets. For example, in a market where one retailer held a 60 per cent share and one held a 40 per cent share, a 50 per cent threshold would prevent the larger retailer from growing and the smaller retailer from being able to outgrow the larger one. Though less acute, a threshold of 55 per cent gave rise to similar concerns.

11.103 The same four of us also thought it more appropriate, on balance, to adopt a conservative threshold for what will be a mechanistic test to reduce the risk that welfare-enhancing store developments were prohibited by the test. In doing so, we accept that there may be some cases where a more detailed competition assessment may have failed a development that would have passed the competition test.

11.104 We considered setting the threshold at 70 per cent. However, we found a higher threshold such as 70 per cent to be too high. Set at that level, there would be too great a risk that a substantial number of new developments that would have a negative effect on competition in local markets would pass the competition test. Indeed, we noted that set at this level, a substantial number of store developments would have passed the competition test that would have failed our own more detailed assessment.[1] We therefore decided in this instance by a majority of four members to two to adopt a 60 per cent threshold.

11.105 We also note Sainsbury's arguments about how the test should be made asymmetric, with tougher thresholds for a retailer with national market power compared with the other grocery retailers. However, we did not find an AEC in relation to national market power. Furthermore, our local market analysis in Section 7 shows that Tesco has [✂] monopoly and duopoly stores, whereas Morrisons, Sainsbury's and Asda have [✂] monopoly and duopoly stores respectively. We did not therefore find it appropriate to single out any particular grocery retailer for specific treatment.

11.106 We note Sainsbury's view that the market shares used in the competition test should be based on average revenue figures per sq metre. We decided not to use such a measure, however, because we did not think that it would provide a reasonable indicator of competition. This is, first, because the retailer's national average sales per sq metre may not accurately reflect the actual sales per sq metre of that retailer's store in the local area in question. In addition, average sales per sq metre vary between retailers depending on the extent to which those retailers sell premium products.

11.107 We also gave thought to which fascias and stores should be taken into account in the market share assessment under the competition test. Again, in line with our market definition, and the fascia count, we consider that the market share assessment

[1] Approximately 24 per cent of existing grocery stores would not be able to extend with the competition test at a 60 per cent share threshold. This would reduce to 19 per cent of existing stores at a 70 per cent threshold.

should take account of all stores in the isochrone that are in excess of 1,000 sq metres and operated by any of the full-range national or regional grocery retailers and symbol groups.[1] Independently-owned full-range grocery stores above the 1,000 sq metre threshold should also be taken into account in market share assessment. However, any such sized store operated by the LADs, Iceland and Farmfoods, which sell a limited range of products (see paragraph 3.3), would not be taken into account in applying the test.

11.108 As in relation to the fascia count, account should be taken of developments in prospect only if planning permission has been granted, the identity of the grocery retailer operating the store is clear, and if that retailer can supply data as to the groceries sales area it expects to operate. There may be situations where a retailer applies for planning permission for a development (development A) and there is another development with planning permission in the isochrone where the operator has not yet been determined (development B). In this case, we would expect the competition test to examine the situation where the applicant retailer occupied both developments. There could be cases where the applicant retailer would pass the test if it only occupied development A, but would fail if it were also to occupy development B. We would expect the OFT to specify that, if the retailer were to occupy both developments, the competition test would be failed. The LPA would then require a section 106 agreement with the retailer where the retailer agreed not to occupy development B.

- *Which measure(s) of sales area should be used in the test?*

11.109 We considered which measures of sales area should be used in respect of: the 1,000 sq metres threshold used in determining which applications are subject to the test; the 1,000 sq metres threshold used in determining which grocery stores are taken into account in assessing concentration; and in calculating market shares. In particular, we explored the use of gross internal area, net sales area, and groceries sales area.

11.110 We considered whether the threshold to decide which applications should be subject to the competition test and which stores should be taken into account when applying it should be based on net sales area or groceries sales area. Table 11.1 shows that, for grocery stores larger than 1,000 sq metres, there is little difference between basing the threshold on net sales area or groceries sales area, with only 41 stores (2 per cent of the total number of larger stores) having a net sales area over 1,000 sq metres and groceries sales area less than 1,000 sq metres. Since net sales area is easier to measure, we decided that the threshold for determining which applications should be subject to the test should be based on net sales area.

11.111 For the same reasons set out above, we also think that net sales area should be used in deciding which stores should be taken into account in assessing concentration, both in terms of the fascia count and the market share assessment. However, we do not consider that net sales area should form the basis of the calculation of market shares—see below.

[1]As above, we note that there may be new entrants into the grocery retail sector, or company strategies may change, that would mean that the OFT would periodically need to decide whether particular retailers should be included in the competition test, for example as may be the case if an LAD expanded its range.

TABLE 11.1 **Number of stores in UK with net sales area over 1,000 sq metres and groceries sales area below 1,000 sq metres**

	Number of stores with net sales area over 1,000 sq metres and groceries sales area below 1,000 sq metres	*Total number of stores with net sales area over 1,000 sq metres*
	✂	
Total	41	2,508

Source: CC analysis of main party questionnaire responses.

Note: Other includes: Regional Co-operative stores, Booths, Proudfoot, Costcutter, SPAR, and Budgens.

11.112 We considered whether to use net sales area or groceries sales area for the market share calculation. In principle, our concern is with groceries sales and a market share test based on groceries sales area would best reflect this. However, we were told that figures for groceries sales areas of particular stores are not widely available. In applying the competition test, the OFT would therefore need to rely on figures reported by the retailers themselves. We also thought that retailers should be able to predict the outcome of the competition test with a reasonable degree of certainty, so that, over time, the competition test could be taken into account by large grocery retailers and third parties and will become ‘self-policing’ to a large extent. The lack of visibility of a retailer’s groceries sales area to another retailer would work against this.

11.113 We therefore thought about a number of measures of total sales area. We noted that gross internal areas are relatively visible, not least through planning applications, but considered that since these include non-grocery retail uses such as offices, warehouse and storage space and cafes, they would provide too inaccurate an indication of grocery floorspace. While not as easily visible as gross internal areas, our experience during this investigation is that retailers are more aware of each other’s net sales areas than of their groceries sales areas. We therefore considered whether we could either use net sales area for the market share test or as a proxy for groceries sales area. However, a test based on net sales area would not reflect the difference in the mix of groceries and non-groceries sales area between smaller and larger stores and would ascribe disproportionate weight to the sales area of larger stores.

11.114 We thought that the use of groceries sales area might also be subject to ‘gaming’, since retailers would be able, at the margin, to switch from non-groceries to groceries possibly resulting in a competitor failing the test. During the course of this inquiry we were told by grocery retailers that they did not routinely keep data on groceries sales area. We therefore considered using a formula that related groceries sales area to net sales area based on store size. In general, however, retailers disagreed with this approach, pointing out that there are significant variations in groceries sales area for a given net sales area both within an individual grocery retailer’s store portfolio and between retailers (particularly since different retailers operate different business models). Given this variation, which we thought to be more significant than the relatively limited opportunities for switching between non-grocery and grocery use, we decided that the market share assessment should be performed on the basis of the actual groceries sales areas of those stores included in the assessment.[1]

11.115 We then considered what should constitute 'groceries' for the purpose of calculating groceries sales area. Our terms of reference defined groceries as including: food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods, and excluding: petrol, clothing, DIY products, financial services, pharmaceuticals, newspapers, magazines, greetings cards, CDs, DVDs, video and audio tapes, toys, plants, flowers, perfumes, cosmetics, electrical appliances, kitchen hardware, gardening equipment, books, tobacco and tobacco products. However, in devising the questionnaire that we sent to the main parties at the outset of this inquiry, we were told by the retailers that it was difficult for them to provide data on the basis of this definition. We therefore amended the definition of groceries in our questionnaire to ensure that retailers were able to provide data on the basis of it. We expect that the same practicality issues would arise in respect of groceries sales area calculations for the purposes of the competition test. We therefore consider that the definition of 'groceries' for the purpose of the calculation of groceries sales area in the market share limb of the competition test should be the same as that used in our main party questionnaire, that is including: food (but not restaurants and coffee shops); drink (alcoholic and non-alcoholic); tobacco products and accessories; toiletries, non-prescription medicine, health care and optical goods; household and fabric cleaning products; small household goods (including pots, pans, cutlery); newspapers and periodicals; pet food and accessories; and stationery.

11.116 We identified two possible ways in which data on net groceries sales area might be collected. First, in response to each planning application, grocery retailers could be required to provide details of groceries sales area for stores within the isochrone. Alternatively, grocery retailers could be required to provide the OFT with information for all their stores on an annual basis. This would give the OFT information that it could use in applying the competition test in relation to individual applications without the need to collect it specifically. We noted that the information contained in a database might become outdated so that it was likely that the OFT would in any case need to check the information it had before using it to apply the competition test. Given this, and the costs involved in setting up and maintaining a database, we decided that the collection of data on groceries sales area by the OFT upon being asked to apply the test was preferable.[2]

11.117 We are aware that, for various reasons, some of the large grocery retailers own or control grocery stores which they do not operate under their usual fascia.[3] Our remedy will require all grocery retailers to make a prompt and full disclosure of all stores and sites with planning consent for grocery retail use owned or controlled by them to the OFT on receipt of a request from the OFT for this information in respect of an area in which it is applying the competition test.

11.118 Our concern is with increases in groceries sales area. While the competition test would be applied to such developments, it would not prevent development that solely concerned non-grocery use, such as cafes, provided that there was no prospect that a non-grocery development could facilitate an increase in groceries sales area. This

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[1]We are also persuaded by Asda's argument that it collected data on floorspace allocation as part of its routine performance management because space utilization was important, and we consider it likely that other grocery retailers are likely to collect this information.
[2]However, we note that there may be a commercial opportunity for a central body to collect such information, which would be beneficial to grocery retailers and developers wishing to assess the extent of competition around a potential new store. We do not envisage the OFT giving informal guidance.
[3][✂]

might be the case either because there is already a planning condition in place limiting groceries sales area or because one may be included as part of the planning consent. Similarly if a new development did not result in an increase in groceries sales area, and planning conditions were applied to prevent any such increase, the development would pass the competition test.[1] We note that if an application were made later to vary the planning condition limiting groceries sales area, this would require a new planning application which would be subject to the competition test.

- *The role of the OFT in respect of the competition test*

11.119 Where the OFT advises on a planning application submitted by a grocery retailer, or where the planning application clearly envisages the grocery store being operated by a particular named grocery retailer, the OFT should apply the competition test only on the basis that the grocery store is operated by this particular retailer. In such circumstances, the OFT should not be asked to apply the competition test speculatively on the basis that other grocery retailers would operate the store. Where the OFT advises on a planning application submitted by a third party, where the identity of the grocery retailer is unknown or where a grocery retailer other than a large grocery retailer has been identified, the OFT should apply the competition test on the basis that the store could be operated by each fascia that operates a grocery store in the isochrone of more than 1,000 sq metres (since any fascia not present in the isochrone would pass the test). We note that this will mean that the OFT will need to assess the market share of a maximum of three fascias.

11.120 Given the mechanistic nature of the competition test, we expect that the OFT's advice to LPAs on the application of the test will be relatively simple. In each case, we envisage that the OFT's advice will set out: the application on which it has advised, the precise location around which it has centred the isochrone; which fascia(s) it has assessed as a possible operator(s) of the grocery store; which fascias and stores it has taken into account in assessing whether there are four or more fascias in the isochrone; which fascias and stores it has taken into account in any market share assessments and the grocery floorspace figures it has used in that assessment; whether each fascia it has assessed as a possible operator of the grocery store has passed or failed the competition test.

11.121 Where a planning application has been submitted by a particular grocery retailer or where a particular grocery retailer is clearly envisaged as the operator of the proposed store, and where that retailer would fail the store on the basis of the grocery floorspace proposed in the planning application, the OFT may advise the maximum grocery floorspace that that retailer could develop and pass the test. The OFT may do this where it considers that a small adjustment in grocery floorspace would allow the retailer to pass the test.

11.122 The outcome of the competition test would be capable of legal challenge in one of three ways. First, the OFT could be the subject of an application for judicial review in relation to its performance of the competition test. Given the straightforward nature of the test, we consider it unlikely that many such challenges are likely to be mounted. Second, in taking into account the results of the competition test as part of its decision on the planning application, the LPA could be the subject of an appeal from the applicant. The possibility of such a challenge would in effect be no different from any other challenge of a planning decision by an applicant. Finally, a third party might seek to challenge the LPA's use of the result of the competition test as part of a judicial review of a decision to approve or refuse an application for planning

[1]We would still require the development to be subject to the competition test.

permission. Again, the possibility of such a challenge would not be significantly different from any third party's ability to seek a judicial review. In any case where the LPA is challenged, the OFT may need to be available to support the LPA in the appeal.

Notification of groceries mergers

11.123 We note that the competition test will apply to store developments that would not be subject to merger control. Indeed, in our view the fact that grocery retailers have been able to develop strong positions in local areas outside the scope of merger control is an important reason underlying the need for the competition test. However, we also note that a grocery retailer may be able to avoid the competition test by buying an existing store in the area that already has the necessary planning consent for grocery retailing. Such a transaction would not trigger the application of the competition test and it may also not be subject to the scrutiny of the OFT under merger control because the transaction may not come to the attention of the OFT. In order to prevent such acquisitions being used as a means of circumventing our competition test remedy, we consider that it is important to ensure that the OFT has the opportunity to scrutinize them under the merger control regime. We will therefore require the acquisition by any large grocery retailer of any store with groceries sales area above 1,000 sq metres to be notified to the OFT by the acquiring party.

11.124 In responding to our Provisional Decision on remedies, Waitrose suggested that this remedy amounted to a change in the merger control regime and that, as such, it would require the Government to make changes to the Act through primary legislation. However, it is not our intention to alter the existing merger control regime in any way, and we do not think that this requirement does so. It simply constitutes a requirement on grocery retailers to report acquisitions to the OFT so that the OFT has an opportunity to apply the existing merger control regime if it considers this to be appropriate.

Monitoring and enforcement

11.125 In our view, once the competition test is implemented there would be little need for additional monitoring and enforcement arrangements. The OFT would be consulted as statutory consultee by the LPA as part of the normal consideration of the planning application. We believe that the OFT's publication of its decisions under the competition test will, over time, engender greater understanding among retailers of the way in which the competition test is applied and will lead to self-enforcement.

Other modifications to the planning system

11.126 In the Remedies Notice we also consulted on possible changes to the planning system generally. Some of these proposals were intended to facilitate the availability of land which might be developed for the benefit of the town centre, in particular by *(a)* making a clearer distinction between town-centre and out-of-town-centre sites; and *(b)* reconsidering the role of the quantitative aspects of 'need' in affecting competition between grocery retailers. Further proposals were aimed at streamlining the planning process, thereby reducing one of the barriers to new entry or expansion of competitors in local markets.

Views of the parties

11.127 In our Remedies Notice we asked whether we should recommend that the edge-of-centre site definition should be abandoned.[1] The response of the retailers was mixed. Many told us that this was covered by CLG's proposals on the planning white paper.

11.128 Tesco said that there was merit in abolishing the distinction between edge-of-centre and town centre for the purpose of the sequential test. Waitrose suggested that the sequential and need tests should be retained or, if changed, should retain a strong emphasis on the priority given to the viability and vitality of town centres. M&S considered that the sequential approach should be made more flexible for exceptional circumstances. Somerfield, the ACS and Friends of the Earth were opposed to any changes to the sequential test. CGL was also not in favour of changing the current geographic definitions although agreed that some edge-of-centre development could support the town centre.

11.129 Both Weymouth and Portland Borough Council and Alnwick District Council believed that the distinction between edge-of-centre and out-of-centre sites was important. CLG and the planning bodies of the devolved administrations said that they were committed to the sequential approach and CLG said that it was fundamental to the Government's town centre first policy and to its wider objectives and was 'non-negotiable'.

11.130 In Section 7 we noted that, in practice, a number of retailers see the need test, rather than any of the other tests, as the key barrier to the development of new larger grocery stores in many local areas. Asda, Tesco and Aldi said that the quantitative need test should be removed. M&S suggested that the need test was not required provided that this was accompanied by the introduction of a competition test. Sainsbury's, Somerfield and CGL proposed that the need test could be replaced with a broader test which included quantitative need within the retail impact assessment. Morrisons, the ACS, the BCSC and Friends of the Earth said that the quantitative need test should still be an important factor to be considered with a planning application.

11.131 Both Weymouth and Portland Borough Council and Alnwick District Council were in favour of retaining the current tests. CLG pointed out that the white paper showed that the Government was particularly concerned about the need test and was consulting on proposed revisions. The draft revision of PPS6 will include a new impact test which will supersede the need and retail impact tests. The Scottish Government Planning Directorate told us that need was not a specific aspect of Scottish planning policy and the Planning Authority of the Welsh Assembly Government expressed a stronger commitment to keeping the need test.

11.132 Sainsbury's, Tesco and Asda all suggested that they would welcome remedies to streamline the planning system, although the ACS considered these policy considerations to be outside the remit of competition policy.

Our views

11.133 We noted in paragraphs 7.35 to 7.38 the various aims and objectives of the planning system and have expressed our concern at the possibility of unintended

[1] In asking this question, we were considering whether the planning system should recognize that some edge-of-centre sites could benefit the town centre because of the functional relationship that exists between the two, while others could more appropriately be classified as out-of-centre sites. There are currently four planning designations used by LPAs: town centre; edge-of-centre; out-of-centre; and out-of-town. Full definitions of each of these terms can be found in the Glossary.

consequences arising from changes made to benefit competition. We are also aware that the Government already proposes to change the planning system in England, recognizing that the need test may not be functioning as was intended. Following the recommendations of the Barker Report,[1] the Planning White Paper[2] proposed replacing the need test and the impact test[3] with a new test which has a strong focus on the town centre first policy, promotes competition and improves consumer choice, avoiding the unintended effects of the current need test.

11.134 We do not envisage the competition test being a replacement for the need test. We consider that the competition test would be necessary to address the AEC that we have found whether or not the current need test were retained because (as noted in paragraph 11.24) the need test is applied on an 'identity-blind' basis whereas a key point of the competition test would be to control the identity of the occupant. In assessing need, LPAs have no ability to consider whether, even if there is need for a new development, the consequences of allowing that need to be fulfilled by a particular retailer would have anti-competitive effects.

11.135 We recommend that LPAs take greater account of competition in their development plans. We decided not to recommend any specific changes to the planning system (beyond the competition test). We are concerned that there is a risk of unintended consequences that could arise from interfering more than is necessary with an area of policy that has specific and well-defined social objectives and which is itself subject to a process of public consultation and reform. It is important to note that in choosing and designing our remedies in relation to the planning regime, we have taken account of the reforms proposed in Planning White Paper. Our remedies are additional to those reforms and do not preclude any of the reforms proposed in the Planning White Paper in any way.

Controlled landsites

11.136 We next set out our decisions on remedies in relation to existing and future controlled landsites. We consider, in particular:

- restrictive covenants (see paragraphs 11.137 to 11.182);
- exclusivity arrangements (see paragraphs 11.183 to 11.230);
- land bank sites (see paragraphs 11.232 to 11.243); and
- leases to third parties (see paragraphs 11.244 to 11.249).

Restrictive covenants

11.137 We consider below remedies designed to address restrictive covenants. In paragrah 7.88 we explained that a restrictive covenant is a restriction typically imposed on the sale of freehold land that limits the future use of the land. It is imposed on the sale of the freehold. Our remedies to address restrictive covenants are therefore aimed at restrictions imposed on the sale of freehold property. We also considered whether it is necessary to prevent grocery retailers from imposing contractual restrictions with the same effect, eg in leases (see paragraph 7.87).

[1]The Barker Review of Land Use Planning, Final Report—Recommendations, Kate Barker, December 2006.
[2]*Planning for a Sustainable Future:* White Paper, 21 May 2007.
[3]In the case of a retail development, this is the retail impact assessment.

Summary of remedy

11.138 To address the AEC we have found arising from restrictive covenants which act as a barrier to entry in a number of highly-concentrated local markets, we decided to implement the following remedies:

(a) In relation to the 30 restrictive covenants referred to in paragraph 7.113, the grocery retailer that benefits from each restrictive covenant in question must release the burdened land from the restrictive covenants by entering into a deed of release. In addition, that grocery retailer must make a full and proper application to the Land Registry to remove the restrictive covenants from the Charges Register. These steps must be taken within six months of the date of this report.

(b) In relation to existing restrictive covenants that were not referred to in paragraph 7.113, any large grocery retailer must release any restrictive covenant that relates to land in a highly-concentrated local market where it has a strong local market position, and which may restrict grocery retailing or have equivalent effect. Such restrictive covenants will be identified when:

(i) the owner of the burdened land applies to the OFT; and

(ii) the OFT applies the competition test (in a similar way as in relation to the planning remedies but adapted to apply to mid-sized as well as larger stores) and determines the area around the stores associated with the burdened land to be a highly-concentrated local market and the grocery retailer benefiting from the restrictions as having a strong local market position.

(c) Large grocery retailers will be prohibited from imposing new restrictive covenants that may restrict grocery retailing or which have equivalent effect. Exceptions will be made to permit:

(i) restrictions in leases granted to tenants of residential dwellings which specify that a leasehold property is to be used only for residential purposes, but they will not be permitted to burden the freehold title of land that they transfer with restrictive covenants which restrict grocery retailing; and

(ii) user clause in leases setting out the specific purpose for which land is to be used and which mirror section 106 obligations .

11.139 In addition to the above measures, which we will implement ourselves, we recommend to LPAs that if they receive applications for lifting existing restrictions imposed as a result of planning obligations or conditions, or if they are considering imposing planning conditions, or entering into section 106 agreements with grocery retailers in the future, they have regard to any adverse effects of the restriction on competition in reaching their decision.

11.140 We further recommend to BERR that it amend the Land Agreements Exclusion Order so that exclusivity arrangements which restrict grocery retailing and which are entered into by grocery retailers which were previously within its scope should no longer benefit from exclusion from the Competition Act 1998.

11.141 Our controlled land remedies envisage the involvement of the OFT. Given the overlaps in its role in relation to these remedies and its role in applying the competition test, the estimates provided by the OFT for its costs in administering the competition test (discussed in paragraphs 11.382 to 11.389) include the costs of administering the controlled land remedies.

11.142 We recognize that the OFT will need to allocate its resources to fulfil these new functions.

Existing restrictive covenants

- *Views of the parties*

11.143 Morrisons, Sainsbury's and Tesco told us that in their view restrictive covenants did not block entry, and they were not in favour of a remedy to address certain existing restrictive covenants imposed by them. Sainsbury's said that this would be an unnecessary interference with grocery retailers' legitimate property rights. Asda accepted that there might be circumstances in which restrictive covenants may restrict competition but said that our proposed remedy to address all exclusivity arrangements in the future was disproportionate.

11.144 Sainsbury's told us that it was willing to waive unilaterally the historic covenants that it held and would undertake not to impose any covenants on future disposals where the effect would be to prevent a competing retailer from using the land. Tesco identified a number of restrictive covenants from which it benefited but which it would be prepared to see removed or not enforced.

11.145 M&S favoured a prohibition on any restrictive covenants that have the effect of reducing the likelihood of land being used for a competing grocery store. It said that there must be a mechanism to determine whether a restrictive covenant had as its object or effect the restriction of grocery retailing. Similarly, Waitrose was not, in principle, against prohibiting restrictive covenants or other agreements that had the effect of reducing the likelihood of land or stores being used by competitors.

11.146 Asda and Sainsbury's said that it was necessary to have regard to the distinction between restrictive covenants which underpinned the ongoing effective operation of a trading store or which preserved value and those which restricted new entry without justification.

11.147 Sainsbury's said that, in the event that there was a requirement for retailers to release restrictive covenants, they should be entitled to receive market value from the beneficiaries of a release given that, without such recompense, landowners may unfairly gain from a remedy which was impossible for retailers to foresee at the time of entering into such arrangements.

11.148 Sainsbury's suggested that the powers of the Lands Tribunal might be another means of addressing barriers to entry arising from restrictive covenants. This is addressed in paragraph 11.178.

11.149 Asda said that our proposed remedies did not take any account of the effect on competition of a restrictive covenant or its potential justification.

- *Our views*

11.150 We considered whether it would be possible to implement measures effectively to address the AEC we have identified without requiring restrictive covenants to be released. In particular, we looked at whether it would be sufficient to prohibit grocery retailers from enforcing the 30 restrictive covenants that we had identified. A grocery retailer could give an undertaking to the owner of burdened land and its successors in title not to enforce the restrictive covenant.

11.151 We decided, however, that a prohibition on enforcing restrictive covenants would not be sufficient because the restrictions would remain registered on the Charges Register of the burdened land, and owners (or potential owners) of that land might not be aware that the restrictive covenants could not be enforced by the grocery retailers. We therefore decided that the burdened land should be released from the restrictive covenant by removing the covenant from the Charges Register. We note that each retailer is required to release only a small number of restrictions and therefore the cost of releasing the restrictive covenants is not high.

11.152 Four of the 30 restrictive covenants referred to in paragraph 7.113 relate to land in Scotland and are therefore subject to the law of Scotland. While feudal real burdens are no longer enforceable,[1] it remains possible to create real burdens, which must relate to land. Real burdens must not be contrary to public policy. For example, they must not operate as a restraint on trade or have the effect of creating a monopoly.[2] We considered therefore whether in the light of this it was appropriate to take remedial action, rather than to rely on the statutory provision, and decided that it was, because it did not put beyond doubt that these provisions would prevent enforcement of the restrictive covenants and because a requirement for them to be removed from the Charges Register would put this beyond doubt.

11.153 Accordingly, in relation to the 30 restrictive covenants referred to in paragraph 7.113, we decided that the grocery retailer that benefits from the restrictive covenant in question must release the burdened land from the restrictive covenant by entering into a deed of release. In addition, the grocery retailer should make a full and proper application to the Land Registry to remove the restrictive covenant from the Charges Register.[3] In order to achieve an effective remedy, we decided that the retailers should do this as soon as possible. We did not understand this to be a complex task, especially given that it relates only to those restrictive covenants we had identified as problematic (see paragraph 7.113). We therefore decided that retailers should do this within six months of the date of this report.

11.154 We also considered which retailers should be covered by our remedies in respect of existing restrictive covenants. We considered that, in line with our market definition (see Section 4), our remedies in respect of existing restrictive covenants should apply to all large grocery retailers. We considered whether to apply our remedy only to those retailers named in our report as large grocery retailers. This would have the advantage of certainty and clarity. However, we noted that the list of those retailers that would be classed as large grocery retailers according to our market definition may change over time. We therefore considered that it was important for the effectiveness of our remedy to ensure that it applied to all those retailers that would be classed as large grocery retailers in line with our market definition. This list currently comprises Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. However, it may be revised by the OFT as appropriate over time, having regard to our approach to market definition as set out in Section 4.

- *Comprehensive records of existing restrictive covenants*

11.155 As explained in Section 7, the large grocery retailers were unable to provide us with comprehensive records of restrictive covenants which they had imposed prior to 2000 and we did not receive details of any restrictive covenants imposed since 2006.

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[1]Since the Abolition of Feudal Tenure etc (Scotland) Act 2000.
[2]See section 3 Title Conditions (Scotland) Act 2003.
[3]If the land in question is unregistered, a deed of release should still be entered into, and an application made to have the restrictive covenant removed from the Land Charges Register. If the land in question is in Scotland, the real burden should be discharged by the grocery retailer registering against the burdened land a deed of discharge in accordance with section 15(1) of the Title Conditions (Scotland) Act 2003.

In addition, these parties did not provide us with comprehensive details of all restrictive covenants imposed on the sale of land after June 2006. We thought it likely that some restrictive covenants for which records have not been provided to us will also be barriers to entry in highly-concentrated local markets. The simplest and most certain way for us to ensure that any existing restrictive covenants in highly-concentrated local areas do not continue to give rise to an adverse effect on competition would be to require grocery retailers to release all restrictive covenants. However, we note that the existence of a restrictive covenant may have affected the value of the land in past transactions and we therefore do not wish to interfere with existing restrictive covenants which do not give rise to an adverse effect on competition. We therefore decided that it was appropriate only to require the release of those restrictive covenants that relate to land in highly-concentrated local markets and which may restrict grocery retailing or which have equivalent effect.

11.156 Any owner of land burdened by a restrictive covenant which restricts grocery retailing and which was imposed by a large grocery retailer that wishes to have an existing restrictive covenant released may make an application to the OFT. The process of identifying whether or not a large grocery retailer is required to release a restrictive covenant will begin with an application by the owner of the burdened land to the OFT. The OFT will analyse the local market in order to ascertain whether it is highly concentrated. We considered the methodology which the OFT should use in order to analyse a local market for this purpose. We considered, in particular, whether the OFT should apply a mechanistic test along the lines of our competition test, or whether it should undertake a more detailed analysis similar to that which we have undertaken when considering highly-concentrated local markets.

11.157 The competition test would need to be adapted so that the drive-time isochrone would be centred on existing stores associated with the restrictive covenant and so that the test applies to mid-sized as well as larger stores. Nonetheless, the principles of the competition test are clear, certain and easy to apply. We thought that this would be more effective than proposing that the OFT replicate the more nuanced analysis that we undertook when considering highly-concentrated local markets. We therefore decided that it would be appropriate for the OFT to use the competition test when considering existing restrictive covenants that are brought to its attention since this would achieve an effective and practicable remedy.

11.158 The competition test, as we have explained, will not replicate the controlled landsite analysis that we have conducted in the course of the investigation. We cannot therefore rule out the possibility that its application may lead to different outcomes. Having regard to the factors that are encompassed in the test, however, and in particular the thresholds at which the test is passed; and taking into account the advantages to the grocery retailers of a competition test that is clear, certain and easy to apply, we consider that it is appropriate to apply the competition test to restrictive covenants in relation to which we have no information.

11.159 The competition test to be applied to controlled landsites is set out in detail in Appendix 11.1. In the event that the restrictive covenant does relate to land in a highly-concentrated local market, the grocery retailer must release the burdened land from the restrictive covenant by taking the steps set out in paragraphs 11.156 and 11.157.

- *Possible compensation for release of restrictive covenants*

11.160 We considered whether grocery retailers should receive compensation for releasing existing restrictive covenants. It is our view that they should not. We do not believe that it is appropriate to compensate parties for the loss of an anti-competitive benefit.

Indeed, we thought that the prospect of paying compensation to a grocery retailer for the release of a restrictive covenant could deter the owner of the burdened land from seeking the release of a restrictive covenant, thereby undermining the effectiveness of our remedy.

Future use of restrictive covenants

11.161 We considered whether a remedy that stopped short of an absolute prohibition on restrictive covenants in the future might be effective. It might, for example, be possible to limit the areas in which restrictive covenants could be imposed or their permitted duration.

- *Views of the parties*

11.162 Each of the four largest grocery retailers told us that in their view a total prohibition on the use of restrictive covenants in the future which may restrict grocery retailing or which have equivalent effect would be disproportionate, both because there are justifiable reasons for restrictive covenants and because we have not made an adverse finding as regards all restrictive covenants. Asda, Morrisons and Sainsbury's said that any remedy relating to restrictive covenants should be limited to areas of high concentration only. Asda said that any remedy to address restrictive covenants in the future should allow the effect on competition to be taken into account.

11.163 Sainsbury's said that a remedy curtailing the contractual freedom of grocery retailers (as opposed to other land users) would be disproportionate given the limited concerns we had identified in this area.

11.164 Tesco said that such a prohibition could have unintended consequences. In relation to residential homes in mixed use developments, Tesco told us that it took on mixed-use schemes and regeneration projects, with sometimes hundreds of flats being brought forward alongside leisure and retail uses. To protect the amenity of residential tenants, Tesco told us that (as was standard practice in residential leases) it often included a clause in the lease to ensure that the property in question must be used for residential purposes. Accordingly, Tesco said that one effect of our proposed prohibition would be that it would not be possible for a grocery retailer to include restrictive covenants to protect the amenity of residential tenants. Tesco proposed a carve-out to permit the delivery of mixed-use schemes.

11.165 M&S and Sainsbury's were concerned about any recommendation to LPAs that they should not enter into section 106 agreements in the future that include restrictions on the use of former stores. M&S said that it thought it was inappropriate for us to substitute our view on restrictive covenants when we were not aware of the local planning issues and were not experienced in exercising the discretion or judgement of an LPA. Sainsbury's argued that there may be good planning reasons for such a restriction and should an LPA be prevented from imposing such a restriction, this might hinder the grant of planning applications in the future.

11.166 Tesco and Sainsbury's suggested that the powers of the Lands Tribunal might be another means of addressing barriers to entry arising from restrictive covenants. Under section 84 of the Law of Property Act 1925, the Lands Tribunal has the power to discharge or modify restrictive covenants affecting land in certain circumstances.

- *Our views*

  - *Future use of restrictive covenants in highly-concentrated local markets*

11.167 We considered whether grocery retailers should be prohibited from imposing or entering into restrictive covenants in the future which may restrict grocery retailing or which have equivalent effect only in highly-concentrated local markets.

11.168 We considered whether highly-concentrated markets were likely to arise in the future, particularly in the light of our planning remedy. The competition test is designed to ensure that highly-concentrated local markets do not emerge in the future. However, it will not prevent highly-concentrated local markets arising through store closures or disposals of landsites, and restrictive covenants are often imposed in such circumstances.

11.169 In principle, we are attracted to the proposal that future restrictive covenants should be prohibited only in highly-concentrated local markets as this corresponds to the circumstance in which we have found existing restrictive covenants to be a significant barrier to entry. We are concerned, however, that such a remedy would not be effective over time having regard to the fact that a restrictive covenant may exist in perpetuity. A restrictive covenant may be permitted at a particular point in time when it relates to a site in a market which is not highly concentrated. However, the market might become highly concentrated in the future, at which point the restrictive covenant may become a significant barrier to entry.

  - *Time-limited restrictive covenants in the future*

11.170 We considered whether simply to limit the period of permitted restriction, noting that seven of the 30 restrictive covenants that we identified in highly-concentrated local markets are for limited duration. We thought, however, that even a limited period of restriction would impose a barrier and the only benefit it would provide would be anti-competitive. Such a remedy would be less simple to monitor than an overall prohibition and would, in part, be reliant upon owners of burdened land monitoring compliance themselves bringing to the OFT's attention any restrictive covenants that exceeded the permitted period. Similar disadvantages to those discussed in paragraph 11.151 concerning the awareness of third parties would apply to this remedy also. We therefore decided that a time-limited restrictive covenant was not appropriate.

  - *Competition Act 1998*

11.171 We considered whether the operation of the Chapter I and Chapter II provisions of the Competition Act 1998 might be sufficient to address our concerns in relation to restrictive covenants in the future. We decided it would not. These provisions already apply to restrictive covenants but have not prevented the problematic restrictive covenants that we have identified. In addition, it is not clear that these provisions of the Competition Act 1998 would prevent grocery retailers in the future entering into restrictive covenants in all cases which we have found to be problematic.

  - *Application of remedy*

11.172 We considered which grocery retailers should be subject to our remedy in relation to the future use of restrictive covenants. Our analysis of existing restrictive covenants suggested that only large grocery retailers are likely to have a strong position in a local market which can be maintained or strengthened by the sale of land subject to a restrictive covenant. We therefore decided that only large grocery retailers should be subject to our remedies in relation to the future use of restrictive covenants.

11.173 We considered whether, in terms of restrictive covenants which restrict grocery retailing, large grocery retailers should be prohibited from burdening any land they transfer or only land which is suitable for mid-sized or larger grocery stores. In our view, it can be difficult to know whether land is suitable for grocery retailing. A requirement to carry out such an assessment could undermine the effectiveness of our remedy. In addition, sites which are not in themselves suitable for mid-sized or larger grocery stores can be assembled into a larger site which may be suitable for mid-sized or larger grocery stores. Accordingly, we decided to prohibit large grocery retailers from burdening the freehold title of any land they transfer with restrictive covenants which may restrict grocery retailing or which have equivalent effect.

- *Restrictive covenants and section 106 agreements*

11.174 We found a number of restrictions on land use that have been notified to us as restrictive covenants and described as such by the parties but which are in fact restrictions resulting from planning conditions or planning obligations. Such conditions are imposed on the grant of planning permission while obligations arise by virtue of section 106 of the Town and Country Planning Act 1990 (see Appendix 7.2).

11.175 Section 106 of the Town and Country Planning Act 1990 provides that an LPA may enter into an agreement with any person interested in land in their area for the purpose of securing planning obligations, restricting or regulating the development or use of the land, either permanently or for a specified period. Any agreement of this type may contain such provisions as appear to the LPA to be necessary or expedient for the purposes of the agreement. A section 106 agreement may be enforced by the LPA against the person who agreed to the obligation and persons deriving title in respect of the relevant land (including persons deriving a lesser interest in it, eg a lease). An example of a section 106 agreement could involve the LPA in restricting the development of an area of land, or permitting only specified operations to be carried out on it in the future.

11.176 We observed cases where grocery retailers impose restrictive covenants which mirror planning conditions and obligations. In our view, such restrictive covenants are not necessary. Once a planning condition has been complied with, it is satisfied, and accordingly planning conditions do not need to be passed on to successors in title. Successors in title wishing to change the use of the land in question would have to make a fresh planning application. As explained in the preceding paragraph, planning obligations are enforceable against successors in title and therefore additional protection in the form of a restrictive covenant is not necessary.

11.177 Restrictions resulting from planning conditions or planning obligations are not the same as restrictive covenants but, in our view, can have the same effect, and we therefore included them in our analysis of restrictive covenants as a barrier to entry. However, we recognize that it will not be possible for a grocery retailer unilaterally to lift such a restriction; lifting the restriction will require the agreement of the LPA. We understand that it is open to anyone to apply to an LPA for the lifting of such restrictions, and we would expect that a grocery retailer wishing to use land in contravention of such a restriction would indeed apply for it to be lifted. We therefore decided to recommend to LPAs that if they receive applications for lifting such restrictions, consider imposing planning conditions, or consider whether to enter into section 106 agreements with grocery retailers in the future, they have regard to any adverse effects of the restriction on competition in reaching their decision. This does not, in our view, hinder the decision-making powers of LPAs in any way. Our proposed changes to the planning regime will clarify the ability of LPAs to have regard to such adverse effects on competition.

- *Use of Lands Tribunal to modify or discharge restrictive covenants*

11.178 We considered recommending greater publicity and more widespread use of the Lands Tribunal's powers in respect of restrictive covenants. We note, however, that the considerations which the Lands Tribunal takes into account when reaching a decision do not include competition considerations. Thus, in our view, the possibility of the Lands Tribunal modifying or overturning restrictive covenants is not sufficient to address our concerns in future, and we did not pursue this possibility any further.

- *Anti-avoidance provisions*

11.179 We note that it would be possible to enter into contracts that would achieve similar, anti-competitive, effects to those of restrictive covenants. As an anti-avoidance mechanism, we therefore decided that grocery retailers must not enter into contractual arrangements which may restrict grocery retailing or which have equivalent effect. This includes clauses in leases. However, we considered two limited exceptions to this general rule in relation to residential property and to user clauses in leases setting out the specific purpose for which land is to be used and which mirror planning conditions or obligations.

11.180 We considered whether our remedy addressing restrictive covenants would have a detrimental impact on residential developments and whether it was necessary to include a carve-out for residential property (see paragraph 11.164). We recognize that it is not uncommon for provisions to be included in the terms of a lease whereby the lessee agrees to a restriction on the use of the property relating to the lease. Our remedies are aimed at addressing those instances where the control of land frustrates entry by rival grocery retailers and we do not wish to interfere unduly with good residential leasehold estate management. We note that it has not been suggested that the requirement to release certain existing restrictive covenants in highly-concentrated local markets would have an effect on residential tenants. We therefore considered the impact of our remedy only as regards the future use of restrictive covenants.

11.181 We acknowledge that restrictions on the use of leasehold residential premises are customary and give necessary protection to the residential leaseholder. In a building or property in which there are multiple tenants (such as a block of flats) with a common landlord, it is usual for each lease granted to contain similar restrictions on use and for lessees to have a means of securing compliance with the restriction by other lessees in the building. We acknowledge therefore that a grocery retailer should not be prevented from including such restrictions in leases relating to residential premises, for the benefit of the lessees. We do not find that it is necessary to secure that protection also by a restrictive covenant on the freehold title. Once the grocery retailer has sold the land, it should no longer be able to control the use of land—planning permission would be necessary for a change of use and therefore the planning system will regulate the purpose for which land is used. Accordingly a restrictive covenant is not required. We therefore decided to allow a limited carve-out which will permit restrictions in leases granted to tenants of residential dwellings which specify that a leasehold property is to be used only for residential purposes. Accordingly large grocery retailers acting as developers will be permitted to include clauses which specify that a leasehold property is to be used only for residential purposes, in the leases they grant, but will not be permitted to burden the freehold title of land that they transfer with restrictive covenants which restrict grocery retailing.

11.182 We also note that user clauses in leases specifying the purpose for which a property must be used to reflect the terms of a section 106 obligation are common and we acknowledge that LPAs often have good reasons for requiring these. Accordingly, we decided that user clauses in leases setting out the specific purpose for which land is to be used and which mirror section 106 obligations should be allowed.

Exclusivity arrangements

Summary of remedy

11.183 To address the AEC we have found arising from restrictive covenants which act as a barrier to entry in a number of highly-concentrated local markets, we decided to implement the following remedies:

- Large grocery retailers with a strong local market position in a highly-concentrated local market will be prohibited from enforcing any of the 30 existing exclusivity arrangements referred to in paragraph 7.113, which are identified as being in highly-concentrated local markets, after five years have elapsed since the publication of this report.

- In relation to any existing exclusivity arrangements not referred to in paragraph 7.113, a large grocery must not enforce or seek the enforcement by others of any such exclusivity arrangement after the longer of *(a)* five years from the date of our report or *(b)* five years from the date the grocery retail store was opened, where that arrangement relates to land in a highly-concentrated local market where it has a strong local market position, and which may restrict grocery retailing or have equivalent effect. Such exclusivity arrangements will be identified when:

  (a) a person who agreed to give a grocery retailer exclusivity or any company wishing to develop a grocery retail store on the site covered by the exclusivity arrangement applies to the OFT; and

  (b) the OFT applies the competition test (in a similar way as in relation to the planning remedies but adapted to apply to mid-sized as well as larger stores) and determines the area around the store(s) associated with the land subject to exclusivity to be a highly-concentrated local market and the grocery retailer benefiting from the exclusivity as having a strong local market position in that market.

- Large grocery retailers will be prohibited from enforcing or seeking the enforcement by others of new exclusivity arrangements once a period of five years from the opening of the grocery store to which the exclusivity arrangement relates has elapsed.

- We recommend to local authorities that they do not enter into any exclusivity arrangement in the future which may restrict grocery retailing or which have equivalent effect for a period of more than five years from the store opening.

11.184 For the purposes of these remedies, a large grocery retailer is one falling within that definition as set out in Section 4. This list currently comprises Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. The list may be revised by the OFT as appropriate over time, having regard to our approach to market definition as set out in Section 4.

Existing exclusivity arrangements

- *Views of the parties*

11.185 Sainsbury's and Tesco were against a remedy to address existing exclusivity arrangements in highly-concentrated local markets. Tesco noted that exclusivity agreements were an important means for developers to attract retail anchors to shopping centres, and they had encouraged retailers in the past to take on risky and difficult regeneration schemes. In the interests of assisting the CC, Tesco identified a number of exclusivity agreements which it would be prepared not to enforce. Sainsbury's said that, if we were to decide that a remedy to address exclusivity arrangements was necessary, any remedy should permit exclusivity arrangements for a minimum of ten years. Tesco said that if we were minded to pursue such a remedy, [✂].

11.186 Sainsbury's told us that without the protection of exclusivity arrangements, it would not have been prepared to enter a number of schemes.[1] Tesco said that the CC's proposed prohibition of exclusivity arrangements could lead to fewer stores being built than would otherwise have been the case. In particular, Tesco was concerned that supermarkets may be less able to take on risky and difficult regeneration schemes in future. Sainsbury's and Tesco also said that it would not be appropriate to impose a retrospective remedy on exclusivity arrangements for which they had already paid on the basis of a legitimate expectation that they would be given protection in return for the risk taken by them. Sainsbury's said that this would not be appropriate given that it would completely undermine the risk appraisal that a retailer would have undertaken when assessing what investment it was prepared to make to enter a particular scheme. [✂], however, identified a number of exclusivity arrangements from which it benefited but which it would be prepared to see removed or not enforced.

11.187 Asda, Morrisons and Sainsbury's provided capital investment appraisals showing the length of time taken for a store to reach mature sales,[2] ie a stable revenue and customer base to provide the required return on investment. Tesco provided some example standard appraisals for a number of stores showing the return on investment expected. Tesco's standard assumption was that stores reached mature sales after three years.[3] The evidence provided by [✂] showed mature sales in [✂] years. [✂] told us that it took [✂] years for its stores to reach maturity and [✂] estimated that it took around [✂] years.

11.188 Sainsbury's said that in the event that there was a requirement for retailers to release exclusivity arrangements, they should be entitled to receive market value from the beneficiaries of a release given that, without such recompense, landlords may unfairly gain from a remedy which was impossible for retailers to foresee at the time of entering into such arrangements.

11.189 Asda accepted that there may be circumstances in which exclusivity arrangements may restrict competition. M&S said that all exclusivity arrangements that had the effect of reducing the likelihood of the land being used for a competing grocery store should be prohibited.

[1] Examples include the Sainsbury's stores in [✂].
[2] A store is assumed to reach maturity at a point when its sales per week are projected to grow at a rate at or around inflation.
[3] However, Tesco said that this did not mean the investment was profitable after three years. For many stores, the payback period was much longer. Tesco explained that exclusivity agreements provided Tesco with the necessary security to invest in these long-term projects which brought wider benefits to local communities.

11.190 M&S said that it acted as the anchor tenant in major developments, and in such circumstances it did not require exclusivity arrangements in order to justify its investment. It said that all exclusivity arrangements that had the effect of restricting grocery retailing should be prohibited by way of an industry-wide order. M&S favoured a presumption of illegality which required the party with the benefit of the agreement to establish legality. There would also need to be a mechanism for resolving disputes about legality.

- *Our views*

11.191 We note that while grocery retailers benefit from exclusivity arrangements, it is usually a third party, such as a developer or a local authority, which grants exclusivity. We recognize that any effective remedy aimed at addressing the competition concerns arising from exclusivity arrangements must take into account the involvement of third parties not subject to the investigation. We note that exclusivity is given to a grocery retailer by a third party (typically a lessor, developer or local authority), usually in a contract. In fulfilment of the exclusivity, the third party will impose restrictions on others (such as other retail occupants). The restriction is typically a provision of the lease granted to the other occupants. Thus there may be several contracts in place that give effect to the exclusivity from which the grocery retailer benefits. We decided therefore that rather than seeking to vary these contracts, we would prohibit the grocery retailers from enforcing the exclusivity arrangement.

11.192 We assessed whether it would be possible to implement measures effectively to address the AEC we identified without prohibiting grocery retailers from enforcing all existing exclusivity arrangements in highly-concentrated local markets. In paragraph 7.94 we noted that exclusivity arrangements are often associated with developments and that in some cases we were told that the development may not have proceeded without the grocery retailer obtaining an exclusivity arrangement. We were unable to test whether this was in fact the case in respect of any of the exclusivity arrangements we identified as acting as barriers in highly-concentrated local markets. We recognize, however, that the availability of the exclusivity arrangement may have been instrumental to the development of some of these. We recognize also that the availability of exclusivity arrangements were likely to have been relevant in the negotiations of the terms on which the grocery retailer participated in the store. However, given that we have found that these exclusivity arrangements act as barriers to entry in highly-concentrated local markets, we decided nevertheless that we should seek to put in place an effective remedy.

11.193 We considered whether we should prohibit grocery retailers from enforcing existing exclusivity arrangements with immediate effect or whether such arrangements should be permitted for a further period of time to acknowledge that they were entered into following commercial negotiations in the expectation that they would be enforceable (see paragraph 11.186). We note from the parties' capital investment appraisals (see paragraph 11.187) that the longest period which the four largest retailers estimated it would take for stores to reach maturity was five years.

11.194 We therefore decided that the 30 exclusivity arrangements referred to in paragraph 7.113 should have the benefit of a five-year period of exclusivity, beginning from the date of our final report.[1]

[1]We note that, in practice, since the period commences on the date of publication of our final report, the actual period of exclusivity a retailer will have enjoyed for any individual site will exceed five years since it will also include the period of exclusivity prior to the publication date.

11.195 As explained in Section 7, the large grocery retailers were unable to provide us with comprehensive records of exclusivity arrangements from which they had benefited prior to 2000 and we did not receive details of any exclusivity arrangements put in place since 2006. We thought it likely that some exclusivity arrangements for which records have not been provided to us will also be barriers to entry in highly-concentrated local markets.

11.196 We decided to adopt an approach which is similar to the one taken in relation to restrictive covenants for which records have not been provided to us (see paragraph 11.155). We decided that grocery retailers must not take steps to enforce exclusivity arrangements which may restrict grocery retailing or which have equivalent effect in highly-concentrated local markets as set out below.

11.197 Any person who agreed to give a grocery retailer exclusivity or any company wishing to develop a grocery retail store on the site covered by the exclusivity arrangement which may restrict grocery retailing or which have equivalent effect may make an application to the OFT which will analyse a local market in order to ascertain whether it is highly concentrated. If the OFT finds the market to be highly concentrated, and the retailer benefiting from the exclusivity arrangement has a strong local market position, that grocery retailer must not take any steps to enforce the exclusivity arrangement after the longer of *(a)* five years from the date of our report; or *(b)* five years from the date the store was opened, for those arrangements which have been entered into prior to the publication of this report. The OFT will adopt the same methodology as when it is analysing restrictive covenants (see Appendix 11.1).

11.198 We also considered which retailers should be covered by our remedies in respect of existing exclusivity arrangements. We considered that, in line with our market definition (see Section 4), our remedies in respect of existing restrictive covenants should apply to all large grocery retailers. We considered whether to apply our remedy only to those retailers named in our report as large grocery retailers. This would have the advantage of certainty and clarity. However, we noted that the list of those retailers which would be classed as large grocery retailers according to our market definition may change over time. We therefore considered that it was important for the effectiveness of our remedy to ensure that it applied to all those retailers which would be classed as large grocery retailers in line with our market definition. This list currently comprises Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. However, it may be revised by the OFT as appropriate over time, having regard to our approach to market definition as set out in Section 4.

Possible compensation for non-enforcement of exclusivity arrangements

11.199 We considered whether grocery retailers should receive compensation for not enforcing exclusivity arrangements. It is our view that they should not. We do not believe it is appropriate to compensate parties for the loss of an anti-competitive benefit. Indeed, we thought that the prospect of paying compensation to a grocery retailer for not enforcing exclusivity arrangements could deter the owner of the burdened land from seeking the release of a restrictive covenant, thereby undermining the effectiveness of our remedy.

Future exclusivity arrangements

11.200 We considered how best to ensure that exclusivity arrangements are not put in place in the future which create new barriers to entry. We considered the following options:

- total prohibition on the use of exclusivity arrangements;

- prohibition only in highly-concentrated local markets; and
- time-limited exclusivity arrangements in the future.

11.201 We first discuss the views of the parties on these three options and then, separately, set out our views.

- *Views of the parties*

11.202 Asda said that our remedies relating to future exclusivity arrangements were disproportionate since they did not take into account the effect of such arrangements on competition or the possible justification for the exclusivity arrangements. It said that a more proportionate remedy would be to rely on the Competition Act 1998.

11.203 Sainsbury's said that a remedy curtailing the contractual freedom of grocery retailers (while other land users would remain free to enter into exclusivity arrangements of unlimited duration) would be disproportionate given the limited concerns we had identified in this area. Sainsbury's said that any remedy relating to future exclusivity arrangements should be limited to areas of high concentration only.

11.204 Sainsbury's and Tesco said that restrictions on the ability of grocery retailers to enter into exclusivity arrangements with a duration of more than five years would lead to fewer proposed developments by grocery retailers, especially in regeneration areas. In relation to the duration of exclusivity arrangements, Tesco suggested a period of 15 years on one occasion, but on another occasion suggested a period of three to five years. Sainsbury's said that, to the extent that any time limit was to be placed on exclusivity arrangements in the future, this should be at least ten years to give grocery retailers the confidence to invest in riskier developments. Morrisons suggested that 20 years would be a reasonable period for exclusivity arrangements as this was the time necessary to achieve a full return on an initial investment.

- *Our views*

  - *Absolute prohibition on future exclusivity arrangements*

11.205 We thought about whether a remedy that stopped short of an absolute prohibition on exclusivity arrangements in the future might be effective, limiting, for example, the circumstances in which exclusivity arrangements were permitted, the local markets where they could be entered into, or their duration.

11.206 We thought about whether it would be possible to identify those exclusivity arrangements which were essential to underpinning an investment. The number of grocery retailers interested in the scheme might indicate whether the development needed an anchor tenant to proceed. We thought it likely that in practice, however, it would be difficult to draw such a distinction. We also note that property developers do not always seek expressions of interest from many retailers. We would encourage developers to do so, particularly when they are public bodies. Therefore we do not think that it would be possible readily to distinguish between exclusivity arrangements which underpin investment and those which do not and that it would therefore not be appropriate to include such a distinction in our remedy.

11.207 We decided to recommend to LPAs that, when they are considering whether to enter into exclusivity arrangements in respect of grocery retailing in the future, they have regard to any adverse effects of the arrangement on competition in reaching their decision. Developers (both private and public) may wish to consider seeking tenders from a number of retailers to be able to enter into agreements which reflect the best available commercial terms.

- *Prohibition on future exclusivity arrangements in highly-concentrated local markets*

11.208 We thought about whether it would be appropriate to prohibit grocery retailers from entering into future exclusivity arrangements only in highly concentrated local markets. As explained in paragraph 11.169 in relation to restrictive covenants, we do not think that identifying future highly-concentrated local markets will be straightforward. Similarly, we believe that prohibiting exclusivity arrangements in highly-concentrated local markets will generate commercial uncertainty and would delay commercial transactions. We therefore decided that it would not be practicable to prohibit exclusivity arrangements only in highly-concentrated local markets.

Time-limited exclusivity arrangements in the future

11.209 In paragraph 11.192 we noted that in some circumstances the availability of an exclusivity arrangement may be key to the development. We considered whether, instead of prohibiting all future exclusivity arrangements, we should prohibit only those for which the period of exclusivity exceeded a specified period so that the possible benefits of such exclusivity arrangements could be maintained while limiting the extent of the effects such arrangements have on competition.

11.210 We also explored whether it would be appropriate to limit the duration of all exclusivity arrangements which grocery retailers may enter into or enforce. A time limit could allow developments to proceed, including those for which the grocery store is the anchor store, while reducing our concerns over the duration of the period of exclusivity.

11.211 We thought that a 20-year exclusivity period would not represent a reasonable balance. Indeed, we believe that if we allowed exclusivity arrangements in the order of 20 years we would not be achieving a comprehensive remedy to this aspect of the AEC in highly-concentrated local markets.

11.212 We recognize that there are specificities of each case which make it difficult to identify a number of years which is appropriate in every case in which there is an exclusivity arrangement arising from the situation where an anchor tenant is needed to facilitate a development. We sought to balance the interests of grocery retailers, third parties and the public and the need to facilitate investment against our view that exclusivity arrangements which restrict grocery retailing raise competition concerns. In our view, a five-year period of exclusivity strikes the right balance and is appropriate for the same reasons as set out in relation to existing exclusivity arrangements (see paragraph 11.193). Where our remedies apply to exclusivity arrangements, in the future grocery retailers will be able to make their investment decisions in the knowledge that any exclusivity arrangement will not be permitted to last for more than five years from the opening of the grocery store to which it relates. The fact that this period will begin from the date of opening of the store reflects the fact that this is the point at which the store starts to generate a return.

- *Competition Act 1998*

11.213 We considered whether the operation of the Chapter I and Chapter II provisions of the Competition Act 1998 might be sufficient to address our concerns in relation to exclusivity arrangements in the future. We decided it would not. These provisions could already be applied to exclusivity arrangements[1] but have not prevented the problematic exclusivity arrangements that we have identified. In addition, it is not clear that these provisions of the Competition Act 1998 would prevent grocery retailers in the future entering into exclusivity arrangements in all cases which we have found to be problematic.

- *Application of remedy*

11.214 We thought about which grocery retailers should be subject to our remedies in relation to the future use of exclusivity arrangements. For the reasons set out in paragraph 11.172 in relation to restrictive covenants, we decided that only large grocery retailers should be subject to our remedies in relation to the future use of exclusivity arrangements.

11.215 We explored the possibility that our remedy should apply only to those retailers named in our report as large grocery retailers. This would have the advantage of certainty and clarity. However, we noted that the list of those retailers who would be classed as large grocery retailers according to our market definition may change over time. We therefore considered that it was important for the effectiveness of our remedy to ensure that it applied to all those retailers who would be classed as large grocery retailers in line with our market definition. This list currently comprises Asda, CGL, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose. However, it may be revised by the OFT as appropriate over time, having regard to our approach to market definition as set out in Section 4.

11.216 We thought about whether our remedy in relation to exclusivity arrangements should apply only to land which is suitable for mid-sized or large grocery stores. However, for the reasons set out in paragraph 11.173 in relation to restrictive covenants, we decided to prohibit large grocery retailers from entering into exclusivity arrangements which relate to any land or property which may restrict grocery retailing, or which have equivalent effect and in the case of exclusivity arrangements, with a duration of more than five years from the store opening.

Exclusion Order

11.217 The Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004 (Land Agreements Exclusion Order) provides that the Chapter I prohibition of the Competition Act 1998[2] shall not apply to an agreement to the extent that it is a land agreement. 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.

11.218 We note that one reason[3] for the granting of the Land Agreements Exclusion Order was that restrictive agreements relating to land were thought unlikely to have an appreciable effect on competition.[4] In our view, however, in highly-concentrated local

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[1]Although the Competition Act 1998 (Land Agreements Exclusion and Revocation) Order 2004 (Land Agreements Exclusion Order) provides that the Chapter I prohibition of the Competition Act 1998 shall not apply to an agreement to the extent that it is a land agreement, the Order contains a mechanism for withdrawing the benefit of the exclusion (Article 6) for agreements which raise competition concerns.

[2]The Chapter I prohibition provides that agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade within the UK, and have as their object or effect the prevention, restriction or distortion of competition within the UK, are prohibited unless they are exempt.

[3]Another reason for the introduction of the Exclusion Order was to avoid a large number of precautionary notifications to the OFT for confirmation that an agreement relating to land did not in fact breach the Chapter I prohibition. The system of notification has now been abandoned.

[4]Fourth Standing Committee on Delegated Legislation, 03.02.00 debate on Draft Competition Act 1998 (Land and Vertical Agreements Exclusion) Order 2000.

markets, restrictive covenants or exclusivity arrangements which restrict grocery retailing have an adverse effect upon competition.

11.219 We understand that whereas the Land Agreements Exclusion Order applies to exclusivity arrangements, it may not apply to restrictive covenants. If the exclusion is to apply, the party benefiting from the restriction in question must hold an interest in the land which is the subject of the agreement. In the case of a restrictive covenant, the party benefiting from the restriction has often sold the land which is the subject of the agreement and therefore the Land Agreements Exclusion Order would not apply.

11.220 We explored the possibility of recommending an amendment to the Land Agreements Exclusion Order so that exclusivity arrangements which are currently within its scope, which restrict grocery retailing and which are entered into by grocery retailers, should no longer benefit from it.

- *Views of the parties*

11.221 M&S was in favour of an amendment to the Land Agreements Exclusion Order.

11.222 Morrisons told us that the Land Agreements Exclusion Order already provided for the possibility of the withdrawal of the exclusion of land agreements from the Chapter I prohibition. It went on to say that if we were to consider it proportionate and necessary to disapply the Land Agreements Exclusion Order from all grocery restrictive covenants and exclusivity arrangements, this could represent an effective means of dealing with those controlled land issues which restricted entry in highly-concentrated local markets without automatically preventing the use of restrictions in local markets where they had no adverse effect.

11.223 Sainsbury's said that an amendment to the Land Agreements Exclusion Order was not necessary because the Competition Act 1998 (Chapter II prohibition)[1] and withdrawal mechanism contained in the Land Agreements Exclusion Order provided an effective means of redress. However, notwithstanding this, Sainsbury's said that it would support an amendment to the Land Agreements Exclusion Order.

11.224 Tesco said that in its view the Land Agreements Exclusion Order reflected a clear legislative policy of assisting 'shopping centre owners ... to secure certain key retailers and to offer a mix of retail outlets'.[2] Tesco told us that there was legislative support for exclusivity arrangements in the form of the Land Agreements Exclusion Order.

- *Our views*

11.225 We explored the effect of an amendment to the Land Agreements Exclusion Order bringing land agreements which restrict grocery retailing entered into by grocery retailers outside its scope.

11.226 We thought that the exclusion order had created an impression among some retailers that land agreements were not considered to raise competition concerns. We therefore decided that there was value in amending the Land Agreements Exclusion Order so that it does not exclude arrangements entered into by grocery retailers that restrict grocery retailing.

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[1] Section 17, Competition Act 1998.
[2] Fourth Standing Committee on Delegated Legislation, Thursday 3 February 2000, 4.30pm.

11.227 Arrangements are no longer notified to the OFT[1] but must be assessed for compliance with the Competition Act 1998 by the parties to them. We therefore consider that the amendment of the Order in this way will not precipitate a large number of notifications to the OFT, but would be assessed for compliance with the Competition Act 1998 by grocery retailers, which we consider would be wholly beneficial.

11.228 We gave thought to the question of whether such an amendment to the Land Agreements Exclusion Order should change our view on any of our other remedies in relation to controlled landsites. While we decided that removing exclusivity arrangements entered into by grocery retailers that restrict grocery retail use from the scope of the Land Agreements Exclusion Order would be beneficial, we did not think that this would be sufficient to change our view in relation to any of our other controlled land remedies. The reliance on future action by others to enforce the Competition Act 1998 brings with it uncertainties, and therefore an amendment to the Land Agreements Exclusion Order in the absence of other remedies will not be sufficient to remedy the AEC that we have identified.

11.229 We decided to recommend to BERR that it amend the Land Agreements Exclusion Order so that exclusivity arrangements which restrict grocery retailing and which are entered into by grocery retailers which were previously within its scope should no longer benefit from exclusion from the Competition Act 1998.

11.230 We also observe that there may be merit in revoking the Land Agreements Exclusion Order in its entirety. We thought that it was something of an anomaly in the current competition regime. It may be appropriate for BERR to consider whether the Land Agreements Exclusion Order remains appropriate.

Remedies we decided not to pursue

11.231 In our Remedies Notice we identified a number of other possible remedies which we have decided not to pursue:

(a) remedies to address current and future land bank sites;

(b) remedies to address leases and subleases to third parties; and

(c) remedies which involve strengthening the compulsory purchase order (CPO) process.

We discuss each of these proposals in turn.

Land bank sites

11.232 We thought about *(a)* remedies to address those existing land bank sites that we consider are currently acting as barriers to entry in existing highly-concentrated local markets; and *(b)* remedies to address land bank sites that may act as a barrier to entry in the future.

[1]This is primarily as a result of the coming into force on 1 May 2004 of EC Regulation 1/2003 (the Modernisation Regulation) and subsequent amendments to the Competition Act 1998 in the UK. The Modernisation Regulation created a ‘legal exception’ regime which means that agreements which benefit from an exemption from the application of Article 81 of the EC Treaty are not prohibited, no prior decision from a competition authority to that effect being required.

- *Views of the parties*

11.233 Sainsbury's, M&S and Morrisons in principle supported remedial action to address land bank sites in highly-concentrated local markets where they were being held as a barrier to entry. Sainsbury's considered that the competition assessment should effectively control the opening of new stores space, and thus by implication the acquisition of land, provided that an appropriate test is implemented in a timely fashion. This should, in Sainsbury's opinion, prevent the emergence of areas of high concentration. Waitrose said that it was in favour of a remedy to address land banks both in existing and future highly-concentrated local markets.

11.234 Tesco was against any requirement to divest existing land bank sites. It explained that it worked flexibly with the grain of planning to develop its land bank sites into stores, and said that in its view the CC had found very little evidence of sites being used as barriers to entry. Asda said that other remedies, such as amendments to the planning system, should be preferred to any divestiture remedy.

11.235 Asda, Sainsbury's and Tesco expressed concern at the prospect of a remedy which obliged grocery retailers to divest land banks which had not been developed within a given period. They told us that this was not necessary, could deter site assembly and could interfere with land that grocery retailers had acquired for non-grocery uses.

11.236 Somerfield said that any time limits on land bank sites should only be in highly-concentrated local markets. Morrisons said that any divestiture remedy relating to land bank sites should apply to areas of both existing and prospective high local concentration.

- *Our views*

  - *Existing land bank sites*

11.237 We identified 18 land bank sites in highly-concentrated local markets which raise barriers to entry or frustrate entry, excluding sites where stores have been or are being developed.[1] An analysis of each individual site is set out in Annex C of Appendix 7.2.

11.238 We have not found any evidence of the systematic holding of land by retailers with the sole purpose of creating a barrier to entry by competitors. In most cases, we found that where a retailer holds a land bank site, it is actively pursuing a store on that site. In general, when a retailer has failed to develop a site, it has subsequently sold the site. Of the 18 land bank sites that we have identified as barriers to entry in highly-concentrated local markets, we consider that 17 are potentially suitable for stores because of their size. We note that one of those is already being marketed.

  - *Future land bank sites*

11.239 We thought about whether it was necessary to implement any remedy in relation to land bank sites in the future.

[1]We have taken the view that land bank sites that are in the process of being developed into new stores should not fall within the scope of any remedy aimed at addressing the adverse effect on competition resulting from land holdings (though we have taken the development of any such stores into account in our multiple store analysis). We have identified 52 land bank sites where stores are in the process of being developed (or indeed where stores have opened since we first collected our data) and exclude those from the scope of any land bank remedies.

11.240 We explored the possibility of limiting the period of time for which a grocery retailer could hold land without developing it. We recognize that there would be significant practical difficulties in specifying an acceptable period which would be capable of being applied to every case. We also recognize that it can take a considerable period of time to open a new store and that developments made be delayed by factors beyond the control of the grocery retailer. Accordingly, we thought that there would be a significant risk that any period we adopted would adversely affect the legitimate process of store development, rather than being targeted at sites that constituted barriers to entry.

11.241 We also recognize that grocery retailers are involved in operations other than grocery retailing. We have no desire to curtail the ability of grocery retailers to open non-grocery stores. In practice, however, we thought that any remedy that effectively prevented land bank sites held by grocery retailers acting as a barrier to entry into grocery retailing would not also prevent the holding of land bank sites by these retailers for non-grocery uses.

11.242 We contemplated the possibility of setting up a regular review process relating to land banks, for example by the OFT. However, we reached the view that it would not be possible to establish a clear set of criteria by which the legitimacy of a land holding could be easily assessed by any reviewer. We thought that any meaningful review process would be complex, as it would require the reviewer to consider each undeveloped land holding and assess whether there were legitimate reasons for the land to be held by the grocery retailer without being developed. The uncertainty and unpredictability associated with such a review process could act as a deterrent to legitimate site assembly and store development, and therefore we decided not to pursue it.

11.243 In summary, we do not think that it is appropriate to put in place a remedy specifically designed to deal with land bank sites. We note that as a result of our analysis of highly-concentrated local markets we have found only 18 land bank sites that are acting as barriers to entry. We also note that where retailers have held 'ransom strips' in the past, commercial agreement has usually been reached allowing the development to proceed. Furthermore, we are concerned that practicable and meaningful restrictions on the future holding of land bank sites would inhibit legitimate site assembly. Overall, we concluded that it would not be appropriate for us to take remedial action in relation to land bank sites.

Leases and sub-leases to third parties

11.244 We assessed whether there was a need for remedies to address the existing 12 leases or subleases to third parties that act as barriers to entry in highly-concentrated local markets (see paragraph 7.113) and to prevent leases acting as such barriers in the future.

- *Views of the parties*

11.245 Asda said that any remedy addressing subleases would interfere with a retailer's rights over its own property. Sainsbury's said that subleases to non-grocery retailers did not automatically generate a barrier to entry and that none of the subleases that we had identified as being of concern had resulted in a barrier to entry. Tesco said that a remedy to address current or future subleased stores was unnecessary.

- *Our views*

  - *Existing leases*

11.246 We did not find it appropriate for us to interfere with the terms of leases which have already been negotiated between grocery retailers and parties not involved in our investigation. Accordingly, any potential remedy relating to existing leases and sub-leases could only reasonably be implemented at the point that these leases or sub-leases expire. Accordingly these fall within the scope of our consideration of future leases, which is set out below.

  - *Future leases*

11.247 We thought about whether we should prohibit grocery retailers from leasing or sub-leasing stores to non-grocery retailers in highly-concentrated local markets only in the future. For the reasons set out in relation to addressing future restrictive covenants in highly-concentrated local markets only (see paragraphs 11.167 to 11.169), we did not find this to be an appropriate remedy.

11.248 We therefore also thought about whether we should take action more generally in relation to grocery retailers leasing or subleasing stores to non-grocery retailers in the future. We could require grocery retailers to use their reasonable endeavours to secure competing grocery retail tenants in stores before leasing or subleasing them to a non-competing retailer. However, we understand that many leases or subleases relate to relatively less attractive stores (which may be why the grocery retailer no longer wishes to occupy them) and we are not confident that a competing grocery retail tenant could be found that was willing to pay a reasonable rent. An effective remedy would need to allow for the possibility that a tenant could not be found and monitoring would therefore be difficult. Taking this practical difficulty into account, and noting the limited number of instances where we found leases and subleases to act as barriers to entry in existing highly-concentrated local markets, we decided to take no action in relation to future leases and subleases.

11.249 In summary, we decided to take no action in relation to existing leases or subleases that we identified as barriers to entry in highly-concentrated local markets. We also decided to take no action in relation to future leases and subleases.

Compulsory purchase orders

11.250 We also wondered whether stronger or more frequent use of local authorities' existing compulsory purchase powers might address the AEC that we found in respect of controlled landsites. We thought in particular about whether CPOs could be used by local authorities to acquire land held by grocery retailers if the local authority felt that the landsite was inhibiting development or, more specifically, competition in grocery retailing.

- *Views of the parties*

11.251 Tesco said that strengthening the current policy on the use of CPOs would be an effective remedy to address concerns arising from controlled landsites. CGL suggested that existing compulsory purchase powers of local authorities were currently used too infrequently.

- *Our views*

11.252 We thought about taking steps to strengthen the current policy for using CPOs. CPOs can only be made by a local authority or another statutory body. We note that an LPA can make a CPO to acquire land for development and improvement and the proper planning of an area. A local authority might use a CPO to acquire land if it was part of a wider development, but because a CPO can only be made by a local authority or statutory body, the CPO process is unlikely to be of use to an individual grocery retailer that wishes to acquire a plot of land for commercial development.

11.253 CPOs are essentially a planning power and are not designed to enable landowners to take action because of the terms on which they hold land, eg subject to a restrictive covenant.

11.254 If there is opposition to a CPO which an LPA proposes to make, a public inquiry is usually held before a recommendation is made to the Secretary of State. Even if a CPO could be made for the purposes of acquiring land subject to a restrictive covenant or exclusivity arrangement with a view to releasing that land from the relevant restriction and allowing a grocery retailer to operate a grocery store from it, the risk of having to undergo the process needed to make a contested order would be likely to deter most LPAs.

11.255 It is our view, therefore, that it is not appropriate for us to make such a recommendation.

Multiple stores

11.256 We next set out our reasoning and decisions on remedies in relation to multiple stores that we found give rise to competition concerns in highly-concentrated local markets.

11.257 In addition to the issues we identified around controlled landsites, we identified 57 stores in markets where retailers have a high market share and more than one store. We have not seen evidence of imminent entry in any of these local markets and, as a result, expect high concentration in these markets to persist for some time. In principle, it would be possible to reduce the degree of concentration directly and within a relatively short period of time through the divestiture of one or more stores in these markets. We therefore considered whether it would be appropriate for us to pursue such a remedy.

Views of the parties

11.258 Sainsbury's told us that it did not consider that a remedy to divest stores would be a proportionate remedy to any local concentration issues. Both Sainsbury's and Asda said that reform of the planning regime should instead be used to rebalance local competitive conditions.

11.259 Morrisons said that our findings did not justify store divestitures in highly-concentrated local markets. Morrisons also argued that a store divestiture remedy would not be comprehensive since it would only be possible in areas where a particular fascia had more than one store. Morrisons also said that we should consider the impact of any store divestitures on local market competition between retailers more generally. Morrisons said that store divestitures were likely to benefit retailers with large financial resources, which would make Morrisons the least likely of the four large retailers to benefit.

11.260 M&S said that in principle it considered it appropriate for us to consider store divestitures in those circumstances where we had identified that there was a very high level of concentration within a local market. Somerfield was of the view that divestitures would be appropriate in any local market in which a grocery retailer had an excessive share as long as the market in question was large enough to support (at least) two large grocery outlets.

11.261 We identified 57 stores in highly-concentrated local markets where one (or more) grocery retailer owns or controls more than one trading grocery store (see Appendix 7.2). We also identified four stores in highly-concentrated local markets where grocery retailing is highly concentrated and where a grocery retailer currently owns or controls two stores, one of which is being replaced by the other (replacement stores). We consider each of these situations separately.

Replacement stores

11.262 Where a store is being replaced, a retailer is moving from one location to another and the retailer will only own or control two stores in a local market temporarily. In general, retailers told us that they would seek to dispose of a former store on relocation and we note that our remedies in relation to controlled landsites will ensure that no restrictive covenant or exclusivity arrangement extending beyond five years will be placed on the former store. We therefore decided that it was not necessary to take further steps to address those instances of multiple store ownership or control arising from store replacement.[1]

Multiple trading stores

11.263 The most direct means by which we could address the 57 stores in highly-concentrated local markets where one (or more) grocery retailer owns or controls more than one trading grocery store is by requiring the occupancy of (at least) one of the multiple stores by another retailer which would increase the degree of competition in the local market.

11.264 Although in principle it would be possible for the retailer owning or controlling the store to lease it to a competing grocery retailer rather than selling it, we are concerned that such a remedy would create ongoing links between the two retailers in the local market. The landlord may be able to use its position to disadvantage the tenant in competing with it. Even if we stipulated that we must approve the terms of the lease, the requirement that tenants inform landlords about changes they propose to make to the property could give the landlord information about the strategy of a local competitor that it could use to compete unfairly. We therefore considered that a requirement on grocery retailers to lease former stores would be likely to be an ineffective remedy.

11.265 We explored the question of whether compulsory divestiture of one or more of its stores in a market by the strongest grocery retailer in that market would be an appropriate remedy. We considered the costs that the retailers would incur as a result of any such divestitures. In most of these cases we would expect vigorous competition from other grocery retailers to acquire any divested stores and would expect the vendor to achieve the full market price. The purchase price may be less than the store was worth to the vendor, as it would not include any premium for expected monopoly rents, but this is precisely the problem we would wish to address

[1] In paragraph 11.86 we explain how the competition test will apply to replacement stores for which planning permission is sought.

and is not something that we consider we should take into account. However, we recognize that divestiture represents a very significant intervention in property rights.[1]

11.266 We also believe that there is a significant difference between store divestitures and the other remedies we decided to pursue in relation to highly-concentrated local markets. Whilst our other remedies will ensure that grocery retailers have the opportunity to enter a market to establish a new competing grocery store in the future, store divestitures involve the transfer of ownership of an existing, trading store. In our view, such a transfer could have a disruptive effect on consumers in the short term. Those customers who have chosen to shop at the divested store and who are familiar with that store will either find their store operated by another retailer or will have to find an alternative store to continue shopping with the same retailer.

11.267 In Section 6 (see paragraphs 6.29 to 6.33) we identified two effects resulting from highly-concentrated local markets. The first effect relates to a lower standard of retail offer in the local markets themselves and the second relates to the weakening of those components of the retail offer, such as price, that retailers choose to apply uniformly across all the local markets in which they are present. We believe that the second of these effects will be effectively addressed by the package of remedies we decided to pursue in respect of existing and future controlled landsites (together with the inclusion of the competition test in the planning regime and the requirement on large grocery retailers to notify acquisitions of existing stores in excess of 1,000 sq metres). We decided that the gravity and prevalence of our AEC finding in relation to these markets in respect of the first effect is not sufficient to justify a divestiture remedy.

11.268 Divestitures would represent a significant intervention in property rights, as well as being disruptive to consumers. We do not believe that such an intervention is supported by the gravity and prevalence of the AEC we found. Moreover, we note that store development is a continuing feature in grocery retailing, with the four largest grocery retailers having expanded their UK sales area by 38 per cent between 2000 and 2007 (see Table 2 in Appendix 3.1). Given this, it is our view that removing barriers to entry in highly-concentrated local markets and ensuring that store developments do not exacerbate high concentration will be sufficient over time to address the AEC we have found in relation to highly-concentrated local markets so that there is no need for us to require store divestitures. Indeed, store divestitures in these highly-concentrated local markets would not effectively address concentration: they would constitute a very limited and one-off intervention in a large and dynamic sector. We therefore believe that the competition test and the controlled land remedies will be more effective remedies over time than would be store divestitures.

Supply chain

11.269 We next discuss remedies to address our AEC finding with respect to the groceries supply chain.

Summary of remedy

11.270 To address the AEC we found in relation to supply chain practices, we decided to implement remedies[1]establishing the GSCOP, based on the existing SCOP, but amended such that:

[1]We contrast this position with the usual position in respect of divestitures in completed mergers, in which parties completing a transaction prior to regulatory clearance do so at their own risk.

(a) it applies to all firms which are active in the supply of groceries at a retail level in the UK and which are controlled by corporate groups with, or which themselves have, annual UK retail groceries turnover of £1 billion or more;

(b) the existing formulation in respect of grocery retailers making 'requests' of suppliers remains but, as in the existing definition of 'Unreasonably Require' in the existing SCOP, the burden of proof will be placed on the retailer to demonstrate in all cases where a supplier has complied with a 'request' that it has 'genuinely volunteered' to do so;

(c) an overarching 'fair dealing' provision is included;

(d) an outright prohibition on suppliers being held liable for losses due to shrinkage is included;

(e) a provision that ensures that suppliers are less subject to customer complaint charges is included;

(f) retailers are prohibited from making retrospective adjustments to terms of supply;

(g) retailers must appoint an in-house code compliance officer who will report directly to the audit committee (or non-executive director) and whose report on compliance must be included in the retailer's annual report;

(h) retailers must keep written records of all agreements with suppliers on terms of supply;

(i) retailers must automatically provide their standard terms and conditions to a supplier in writing before they enter into their first contract with that supplier and, at the same time, must:

  (i) inform suppliers of their ability to refuse a request;

  (ii) inform suppliers of their ability to escalate any buyer's decision to a more senior person in the commercial team for further consideration and give that person's contact details;

  (iii) inform suppliers of the identity and the contact details of the in-house code compliance officer and the complaint mechanism;

  (iv) encourage suppliers to provide the in-house code compliance officer with feedback on the relationship with the commercial teams at the retailer; and

  (v) inform suppliers that they cannot be delisted, or have their business with the retailer significantly reduced, for complaining, and that such action will not be taken by the retailer without the supplier receiving reasonable notice in writing;

(j) if a retailer wishes to de-list a supplier or make a significant reduction in the supplier's business with the retailer, it must, concurrently with providing the written notice:

  (i) provide the supplier with a letter setting out the reasons for the retailer taking this action;

[1]Some of the measures listed here may be contained within the GSCOP, others will be implemented separately either by means of undertakings or an order.

(ii) give suppliers an opportunity for an interview with the in-house code compliance officer prior to the decision taking effect; and

(iii) give the supplier notice of its right to escalate decisions for de-listing or having their business with the retailer significantly reduced, to a more senior person within the commercial team;

(k) a retailer or a supplier may refer a dispute to arbitration 21 days after the dispute had been notified to the retailer pursuant to its internal dispute resolution processes;

(l) retailers must enter into binding arbitration, to be conducted by the Ombudsman if such is appointed, and otherwise by an independent recognized expert body (such as the Centre for Excellence in Dispute Resolution (CEDR)) to resolve any dispute with a supplier arising under the GSCOP;

(m) retailers are required to pay compensation or liquidated damages to suppliers for breaches of the GSCOP on the basis of a formula to be included in the GSCOP for the calculation of the amount of compensation or stipulation as to liquidated damages; and

(n) retailers are required to provide to the body monitoring and enforcing the GSCOP and investigating any complaints or resolving any disputes under it with any information it may reasonably require in pursuit of its functions.

11.271 In addition to the above remedies, we decided, by a majority of five to one, to seek undertakings from grocery retailers to establish a GSCOP Ombudsman to monitor and enforce compliance with the GSCOP, and who will:

(a) have an overriding objective of monitoring and enforcing the GSCOP;

(b) gather information (for example, by receiving confidential complaints from suppliers and primary producers regarding breaches of the GSCOP) and proactively investigate retailers' records in areas subject to complaint in order to identify whether breaches of the GSCOP have occurred;

(c) arbitrate disputes between retailers and suppliers arising under the GSCOP that are referred to it;

(d) publish guidance on specific provisions of the GSCOP where it considers that differences of interpretation exist;

(e) report to the OFT on a regular basis regarding the nature of the complaints and disputes it has investigated and publish this annual report; and

(f) not undertake any activity that could facilitate or encourage coordination among retailers or suppliers (such as round-table meetings, dissemination of best practice, and the encouragement of any dialogue between suppliers and grocery retailers outside normal bilateral commercial arrangements).

11.272 In addition, we recommend to BERR that if we do not obtain satisfactory undertakings from the retailers creating the GSCOP Ombudsman within a reasonable period, it should take such steps as are necessary to establish the Ombudsman. We further recommend that, if this is the case, BERR take steps to give the Ombudsman the power to levy significant monetary penalties on retailers for non-compliance with the GSCOP.

11.273 If neither we nor BERR are successful in establishing the Ombudsman within a reasonable period of time, the functions of the Ombudsman will be carried out by the OFT, with the exception of dispute resolution, which will be carried out by a recognized independent dispute resolution body (such as CEDR).

11.274 Our GSCOP remedies, especially if a GSCOP Ombudsman is not established, envisage a role for the OFT. The OFT's estimates of the costs that would be involved in monitoring and enforcing the GSCOP are discussed in paragraph 11.402.

11.275 We recognize that the OFT will need to allocate its resources to fulfil these new functions.

Who will be covered by the GSCOP?

Coverage of grocery retailers

11.276 The SCOP currently applies to each of the four largest grocery retailers—Asda, Morrisons, Sainsbury's and Tesco—in respect of their dealings with their suppliers of groceries. We considered what would be the appropriate coverage for the GSCOP, in the light of our finding on supply chain practices. We first set out the views of the parties and then our views.

Views of the parties

11.277 Sainsbury's argued that retailers with a UK grocery retail turnover below £1 billion could also influence and exercise buyer power within certain product sectors. Iceland argued that a threshold would have differential effects on retailers with turnover either side of the threshold.[1] We recognize that differential effects on retailers is the inevitable result of setting a threshold, and that any such threshold will inevitably be somewhat arbitrary, but consider that practicability considerations outweigh these concerns.

11.278 Iceland also expressed concerns regarding the application of the GSCOP to all grocery retailers within a corporate group, and noted that one of the fascias within its corporate group, Cooltrader, operating in the 'deep discount sector' of frozen food retailing, would face a situation in which few, if any, of its main competitors were subject to the GSCOP. However, the buyer power of a grocery retailer is likely to be at least partially related to the retail groceries turnover of its corporate group, and we would be concerned about the possibility of retailers taking steps to avoid the remedy (for example, creating new subsidiaries or fascias) if the GSCOP did not apply at the level of the corporate group.

Our views

11.279 The current application of the SCOP to Asda, Morrisons, Sainsbury's and Tesco is based on a finding in the 2000 investigation that a grocery retailer had buyer power where its share of national grocery purchases for resale from its store exceeded 8 per cent.[2] Figure 3.1 shows the current shares of national grocery retail sales held by various grocery retailers.

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[1]Based on 2005/06 turnover figures, the largest UK grocery retailer not covered by a threshold set at £1 billion would be Netto, with turnover estimated at £676 million.
[2]*Supermarkets: a report on the supply of groceries from multiple stores in the UK*, TSO, Cm 4842, October 2000, paragraph 1.10.

11.280 We found, however, that all large grocery retailers, wholesalers and buying groups have buyer power in relation to at least some of their suppliers (see paragraph 9.21). During a round-table discussion with grocery suppliers concerning supply chain practices, a number of suppliers ([✂]) told us that, in many cases, retailers not covered by the SCOP have sometimes imposed trading conditions that were worse, in terms of transferring excessive risks and unexpected costs, than those imposed by the retailers covered by the SCOP. In Section 9, we also observe that suppliers reported a greater proportion of adverse practices being carried out by retailers that are not currently covered by the SCOP (see Table 9.3). Given this, our starting point was that, as a matter of principle, the GSCOP should cover all grocery retailers, wholesalers and buying groups.

11.281 However, for reasons of proportionality (which are discussed in more detail below, in paragraphs 11.399 to 11.425), we considered it appropriate to establish a *de minimis* threshold, below which grocery retailers would not be subject to the GSCOP.

11.282 We decided that, for the reasons set out in paragraphs 11.289 to 11.290, the GSCOP should apply to all firms which are:

- active in the supply of groceries at a retail level in the UK; and
- controlled by corporate groups with (or which themselves have) an annual UK retail groceries turnover of £1 billion or more.[1]

Coverage of grocery wholesalers

11.283 Paragraph 9.14 discusses supply chain practices relating to dealings between wholesalers and their suppliers. We concluded that the conduct of wholesalers with respect to their suppliers cannot constitute a 'feature' under the Act, except where the wholesaler is part of a corporate group which operates grocery stores. Accordingly, we came to the view that we could not make findings, or take remedial action (including formal recommendations), with respect to the exercise of buyer power by wholesalers, other than those which own and operate grocery stores.

11.284 We considered whether to extend coverage of the GSCOP to those wholesalers which own and operate grocery stores. Wholesalers that own and operate stores account for only a small portion of overall sales of groceries through symbol groups.

11.285 We concluded that remedial action which applied to certain wholesalers and not to others, based solely on the business structure that a particular wholesaler had adopted, would be open to avoidance, and might distort wholesalers' commercial decisions. If coverage under the GSCOP were based on a wholesaler owning and operating grocery stores, it could ensure that the GSCOP did not apply, by selling its interest in those stores, and our remedy could provide it with an incentive to structure itself in this way. For these reasons, we decided that it would be inappropriate to extend this remedy to those wholesalers which own and operate grocery stores.

Coverage of grocery suppliers

11.286 We considered whether the GSCOP should apply only to certain categories of suppliers.

[1] On the basis of 2005/06 figures, those grocery retailers covered by the GSCOP would be: Tesco, Sainsbury's, Asda, Morrisons, Somerfield, M&S, Waitrose, CGL, Aldi, Iceland and Lidl.

Views of the parties

11.287 A number of non-governmental organizations, including Bananalink and Traidcraft Exchange, expressed concerns that foreign suppliers would not have access to the GSCOP. Asda said that we should endeavour to create a threshold for suppliers' inclusion within the GSCOP. We therefore looked in particular at the inclusion of foreign suppliers and at whether there should be a threshold below which small suppliers would not be included in the GSCOP.

11.288 Asda said that if we did not create a threshold for suppliers' inclusion in the GSCOP, we should recognize when framing our remedies that, in many instances, in its view the balance of bargaining power would be with the supplier. It told us that this could vary on a transaction-by-transaction and product-by-product basis, as well as between suppliers. It said that we should not dampen competition or jeopardize a retailer's ability to bargain for an efficient outcome.

Our views

11.289 In the existing SCOP, foreign suppliers are not excluded from relying on its provisions (see, in particular, the definition of 'supplier' in clause 32 of the SCOP). Similarly, we decided that the GSCOP should apply to dealings between those grocery retailers covered by the code and any suppliers of groceries, so that dealings with foreign suppliers would continue to be covered.

11.290 In paragraph 9.21, we observed that, in certain circumstances, 'the buyer power of even the largest grocery retailers may be offset by the market power of suppliers, particularly those which supply the most prominent branded goods'. This might suggest that certain suppliers could be excluded from the ambit of the GSCOP on the basis of an assessment of their power with respect to the grocery retailers. We considered various possible criteria that could be used in order to determine the likely power of a supplier with respect to a grocery retailer. We noted, however, that, in order to be meaningful, any such criteria would need to be applied to a supplier's dealings in individual products and with individual grocery retailers which would entail significant practical difficulties. These practical difficulties were such that we decided that the GSCOP, as with the SCOP, should apply to the relevant retailers' dealings with all their suppliers.

Extending the GSCOP vertically

11.291 The focus of our market investigation has been on the supply of groceries by retailers, in accordance with the terms of reference from the OFT. However, we also considered whether, in light of the evidence we received, the GSCOP (or some similar code of practice) should apply to commercial relationships that grocery suppliers have with their own suppliers, including primary producers.

11.292 During the course of our investigation, we received a number of complaints from entities which do not deal directly with grocery retailers; in particular, primary producers. The evidence that has been presented to us during our investigation by suppliers to intermediaries and processors, especially primary producers, even if limited in scope, suggests that:

(a) many intermediaries hold buyer power in relation to primary producers;[1] and

(b) supply chain practices transferring excessive risks and uncertain costs up the supply chain are sufficiently prevalent in many sectors to justify greater scrutiny of the nature of these commercial relationships.

11.293 Our consideration of this evidence is set out in paragraphs 9.57 to 9.67, and in Appendices 9.3 to 9.6.

Our views

11.294 Supply chain practices adopted by intermediaries in their dealings with primary producers could not be described as 'features' of the reference market because they do not relate to the structure or conduct of grocery retailers or their customers (see paragraph 9.14). It was therefore not legitimate for the CC to take remedial action (including a formal recommendation) as part of the current market investigation to address these practices.[2]

11.295 We note that, to the extent that pressure from grocery retailers is driving the behaviour of intermediaries further up the supply chain, the establishment of the GSCOP and the Ombudsman may help to alleviate the problems we noted in respect of their transfer of excessive risk and unexpected cost further up the supply chain (see paragraphs 9.47 to 9.49). If it subsequently appears that, despite the operation of the GSCOP (and the Ombudsman), there continues to be a problem to address, we believe that Defra and BERR should consider the introduction of appropriate measures, including the extension of the GSCOP and the role of the Ombudsman or the introduction of a similar, complementary code and arrangements to cover the intermediaries and primary producers. This approach should reduce the likelihood of future calls for consideration by the OFT of this section of the supply chain.

11.296 The content of any such code would need to be a matter of discussion between policy makers, intermediaries and primary producers. The SCOP has been designed to govern the relationship between retailers and their direct suppliers, not those between intermediaries and primary producers. For this reason, many of its provisions would not be relevant to relationships between primary producers and intermediaries, while other practices that are relevant to these relationships (such as the scope of purchasers' rights to reject fresh produce[3]) are not directly addressed by the current terms of the SCOP.[4]

[1]In paragraph 9.27, we have noted that increasing concentration in the groceries supply chain, in the past and in the future, may have an adverse effect on the incomes and profitability of UK primary producers. We expect that increasing and ongoing consolidation by intermediaries in many sectors is likely to confer buyer power on those suppliers in relation to primary producers.

[2]Under the market investigation regime, the CC has the power to take remedial action with respect to 'features' of a relevant market which prevent, restrict or distort competition, or detrimental effects on customers resulting from those features. The definition of 'feature' in section 131(2) of the Act includes conduct (whether or not in the reference market) 'of one or more than one person who supplies or acquires goods or services' in the reference market. The reference market in this case is the supply of groceries *by retailers* in the UK.

[3]The Australian Horticulture Code of Conduct (http://www.daff.gov.au/agriculture-food/hort-crops-wine/hort-policy/code-of-conduct) provides that if a purchaser decides to reject a grower's produce, he or she is required to contact the grower immediately and provide written notification of the rejection and the consequences of the rejection. The Code of Conduct also provides that a purchaser can only reject produce for reasons outlined in a written agreement, and creates a system of independent assessors, who can investigate and report on whether produce was rejected in accord with the agreement and the Code of Conduct, and whether payments by the purchaser were calculated in accordance with the Code of Conduct.

[4]One fresh produce supplier, [✂], submitted that a code of practice covering commercial relations between fresh produce suppliers and their customers would need to address issues such as: prices for 'short season crops' should not be distorted by below-cost selling (unless to clear old stock); a purchaser should not demand additional quantity at the expense of other customers of the grower; loss of profit claims by a purchaser should be balanced against a grower's loss of profit arising from a contract cancellation; and where a purchaser imposes a category management structure, payment for produce should be guaranteed in the event of the category management company going into liquidation.

11.297 Increased transparency would help to reveal supply chain practices and the exercise of buyer power, which might in turn benefit those parts of the groceries supply chain with little or no market power. As discussed in paragraph 11.271, we also intend to encourage transparency in the supply chain by giving primary producers and other suppliers to intermediaries and processors the right to initiate complaints about the conduct of grocery retailers with respect to their direct suppliers.

Content of the GSCOP

11.298 In Section 9, we found that while the SCOP is effective at regulating some retailer supply practices, the transfer of excessive risks and unexpected costs continued, partly because of uncertainty regarding the 'reasonableness' standard employed in many clauses of the SCOP. However, the SCOP is clearly having some effect on the conduct of the four retailers that are subject to it. We note that suppliers report a greater proportion of adverse supply chain practices being carried out by retailers that are not currently covered by the SCOP (see paragraph 11.280).

Views of the parties

11.299 Several of the retailers currently covered by the SCOP said that no change to the terms of the SCOP is necessary. They argued that, as the SCOP is operating adequately, no case had been made for adding to, or tightening, its restrictions. Tesco said that a more prescriptive SCOP was likely to result in higher prices and fewer new products for customers. Asda and Tesco also noted that the OFT's review of the SCOP in 2005 did not suggest that the terms of the SCOP required revision.[1] However, M&S and Waitrose suggested a greater focus on prohibiting retrospective amendment of agreements, consistent with our findings and their own commercial practices when dealing with their suppliers.

11.300 A number of parties (Friends of the Earth, Tescopoly, [✂]) proposed significantly revised codes of practice. These codes were more prescriptive than the existing SCOP, and removed the flexibility afforded by the 'reasonableness' criterion used in many clauses of the existing SCOP. However, these revised codes of practice also addressed issues that were not covered by our AEC finding.

Our views

11.301 We took the provisions of the SCOP as our starting point in considering the content of the GSCOP. We expect that a remedy based on modification of the provisions of the SCOP will be more effective than entirely new regulation, given some parties' familiarity with the SCOP. Moreover, it would not be appropriate to introduce a new code alongside the existing SCOP since the codes would both be aimed at addressing very similar competition concerns.

11.302 In the following paragraphs, we discuss three particular aspects of the GSCOP:

- *(a)* prohibition of retrospective changes to agreed terms of supply (including consequential amendments to the existing provisions of the SCOP);
- *(b)* preservation of commercial flexibility; and
- *(c)* imposition on relevant grocery retailers of a general standard of 'fair dealing'.

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[1] *Supermarkets: The code of practice and other competition issues*—August 2005, OFT 807.

11.303 We also set out, in general terms, the amendments to the individual SCOP provisions which we intend to incorporate into the GSCOP. Further categories of changes, involving retailers' internal processes and external dispute resolution procedures, are discussed in subsequent paragraphs.

Prohibition of retrospective changes to terms of supply

11.304 The principal focus of our concerns with respect to supply chain practices is on retrospective changes to agreed terms of supply.

Views of the parties

11.305 Asda submitted that it would be costly, inflexible and inefficient to require retailers and suppliers to allocate risk up-front. It suggested that a prohibition on retrospective amendments to terms of supply would prevent it from negotiating with suppliers over the terms of overriders (or 'annual turnover bonuses') for past periods, and that 'neither supplier nor retailer would want such rigidity'. We disagree, and consider that negotiations (or 'requests') for retrospective discounts are precisely the sort of supply chain practice that would cause us concern.

Our views

11.306 As explained in paragraphs 9.55 to 9.67, we found that retrospective adjustments made by retailers to the terms of sale increase uncertainty in the assessment of risk by suppliers. This increased uncertainty has the potential to diminish significantly suppliers' incentives to fund investments for the development of new products or capacity, or improved production processes, leading to lower product quality and fewer new product offerings, and therefore, ultimately, to a detriment to consumers. Accordingly, we decided that retrospective changes to agreed terms of supply should be prohibited outright.

11.307 We set out in paragraph 9.46 and its footnote our views regarding two critical issues with respect to the appropriate definition of 'retrospective' in this context:

(a) the point in time beyond which changes become 'retrospective'; and

(b) the extent to which adjustments that are agreed up-front and have retroactive effect can be described as 'retrospective'.

Preservation of commercial flexibility

11.308 The SCOP currently endeavours to strike a balance between being prescriptive and allowing parties a degree of commercial flexibility to reach mutually-beneficial agreements.

Views of the parties

11.309 Several submissions emphasized the importance of the term 'reasonable' in some clauses of the SCOP. In particular, the retailers currently covered by the SCOP, and some suppliers at our suppliers' round-table, were strongly against any proposal to remove the flexibility afforded by that term.

11.310 We also considered the difference between a 'request' and a 'requirement' in the context of a change to the terms of supply. For example, retailers (Asda, Morrisons, Tesco, CGL, Somerfield) submitted that, in the interests of commercial flexibility, retailers must be allowed to request that a supplier pay for the cost of reducing the retail price in order to compete with another retailer after goods have been supplied. Asda said that the OFT had concluded in 2005 that the 'request/require' distinction avoids undue regulatory prescriptiveness. We received various submissions from suppliers (for example, [✂]), on the other hand, suggesting that they did not generally consider 'requests' from retailers to be negotiable. However, during the supplier round-table discussions some larger suppliers said that they were comfortable entering into these discussions with retailers (for example, [✂]).

11.311 The OFT told us that any replacement for the SCOP should not be overly prescriptive, as this could have the effect of deterring collaborative arrangements engaged in by suppliers and retailers for perceived mutual benefit, which could in turn lead to adverse effects on the interests of consumers. Other submissions from the ACS, and many third parties, including BBG, ActionAid, BIFGA, Tescopoly, Friends of the Earth, NFU, NFU Scotland and Bananalink, suggested that the introduction of reasonableness and exceptions into the current SCOP had led to inherent uncertainty and prevented suppliers from relying on the SCOP. Moreover, [✂], told us that the inclusion of 'grey areas' in the SCOP, while done 'for the right reasons', had been regrettable, and that the CC, when now conducting a fresh look at the SCOP, should look to whether some of those grey areas could be eliminated.

Our views

11.312 The ability of grocery retailers to make 'requests' of suppliers under the current SCOP may be undesirable in circumstances where suppliers consider themselves forced to acquiesce to the request (that is, where the 'request' effectively acts as a 'requirement'). However, we also noted that this commercial flexibility brings benefits not only to grocery retailers but also to suppliers, in that it enables mutually-beneficial adjustments to terms of supply. We therefore decided not to impose outright prohibitions on particular conduct (other than in relation to retrospective arrangements—see paragraph 11.270*(f)*—and in respect of suppliers' liability for shrinkage—see paragraph 11.270*(d)*). Instead, we decided to retain the existing formulation in the SCOP, whereby retailers must not directly or indirectly require certain things from suppliers, but remain free to request them. However, as in the definition of 'unreasonably require' in clause 32 of the existing SCOP, we will place the burden of proof on the retailer concerned to demonstrate in all cases where a supplier has complied with a 'request' that the supplier has 'genuinely volunteered' to comply with the request. We envisage that this provision within the GSCOP will be interpreted in the light of the overarching fair-dealing provision (discussed in paragraphs 11.313 to 11.315).

Fair dealing

Views of the parties

11.313 [✂] suggested the inclusion of an overarching principle of 'fair dealing' in the SCOP with a list of sample banned practices, so as to avoid retailers applying a technical interpretation to the clauses of the SCOP. The principle of fair dealing, included in [✂] suggested amendments to the existing SCOP, was based on the Unfair Commercial Practices Directive, the Committee of Advertising Practice Code, and BERR's draft Business Protection from Misleading Marketing Regulations (BPRs). It proposed the following principle of 'fair and lawful dealing':

> A Supermarket will at all times deal with its Suppliers fairly and lawfully. Fair and lawful dealing shall be understood as requiring Supermarkets to conduct their trading relationships with Suppliers, without distinction between ongoing or once-off dealings or between formal or informal arrangements, in good faith, without duress and in recognition of the Suppliers' need for certainty as regards the risks and costs of trading, particularly in relation to production, delivery and payment issues.

Our views

11.314 The SCOP includes an undertaking by the relevant retailers to 'operate under this code in good faith' (Recital (f)—see Appendix 9.7). We decided that the overarching principle in paragraph 11.313 should be incorporated into the GSCOP, on the basis that it would add to the effectiveness of the dispute resolution function by giving the arbitrator a general standard by which to judge retailers' conduct and also because it would add a useful overarching context in which other provisions of the GSCOP could be interpreted (eg in assessing 'requests' from retailers).[1] However, we decided that the reference to 'ongoing or once-off dealings' should be omitted. We were not satisfied that it was reasonable to require that once-off dealings be treated equally with ongoing dealings, since long-term business relationships could involve parties 'trading off' certain obligations and benefits and it would be inappropriate to force terms that are negotiated in the context of a long-term relationship to be applied directly to one-off transactions.

11.315 We consider that the incorporation of this 'fair dealing' provision into the GSCOP represents an important safeguard against the transfer of excessive risk and unexpected cost from grocery retailers to their suppliers. As discussed in relation to 'request' and 'require' in paragraph 11.310, we found it difficult to include in the GSCOP specific restrictions on behaviour that will address the transfer of excessive risk and unexpected cost without unreasonably constraining commercial flexibility on both sides. However, we decided that this overarching 'fair dealing' provision provided a means of constraining behaviour while allowing commercial flexibility where it was appropriate.

Other issues in relation to transfer of excessive risks and unexpected costs

11.316 As noted in paragraph 9.66, while our principal concerns in this area relate to retrospective adjustments to terms of supply, there are, in addition, circumstances where allocations of risk may be agreed up-front between a retailer and supplier, but the extent of risk transferred to the supplier is excessive, since the retailer is best placed to control those risks and the supplier has no capacity to minimize any resulting losses suffered by the retailer.

11.317 As such, we have decided to create an outright prohibition on suppliers being held liable for losses due to shrinkage. We will also incorporate terms in the GSCOP in relation to customer complaint charges, which are different from those in the SCOP and which will reduce the extent to which suppliers are subject to those charges.

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[1]This would be similar to the requirement for 'fair and reasonable terms' in the 'contract rights renewal' undertakings given following the CC's inquiry into the merger of Carlton Communications plc and Granada plc—see paragraph 11.338.

Proposed changes to SCOP provisions

11.318 The actual text of the GSCOP is a matter to be settled in discussion with parties (including both retailers and suppliers' representatives) after the publication of our final report. However, the list in Appendix 11.2 provides an indication of the amendments to the SCOP that we consider necessary or desirable in order to incorporate the changes discussed in paragraphs 11.298 to 11.317.

New internal processes

11.319 In addition to the substantive changes to the SCOP outlined in paragraph 11.318, we identified some positive practices that are currently undertaken by certain retailers that could, if adopted by all grocery retailers subject to the GSCOP, assist in addressing the uncertainty which suppliers have cited as a reason for their lack of confidence in relying on the SCOP.

11.320 With a view to extending this procedural best practice, we decided that obligations should be imposed on retailers with respect to:

- appointment of an in-house code compliance officer (see paragraphs 11.322 to 11.327);
- improved record keeping with respect to supply agreements (see paragraph 11.328); and
- automatic provision to suppliers of contractual terms, rights to complain and details of the dispute resolution procedure (see paragraphs 11.329 to 11.331).

11.321 The requirement to provide contractual terms, rights to complain and details of the dispute resolution procedure to suppliers will be included in the GSCOP itself. Provisions regarding appointment of an in-house code compliance officer and improved record keeping will be covered separately in the order or undertakings which establishes the GSCOP.

In-house code compliance officer

- *Views of the parties*

11.322 With regard to reporting line, Tesco told us that it would not be appropriate for the compliance officer to report to the audit committee. It said that the audit committee was concerned with the strategy of the group as a whole (including pan-global issues) rather than with day-to-day UK issues. Tesco argued that it was inappropriate for its audit committee to have a role in overseeing compliance with the GSCOP. Tesco therefore suggested that the compliance officer report to an executive director, independent of the commercial function.

- *Our views*

11.323 Some retailers have an existing internal dispute resolution process, including an escalation process, whereby suppliers' complaints progress to higher levels of management within the commercial buying team and, ultimately, to a board director. Tesco has created a position of SCOP compliance officer, to provide an alternative avenue within the organization for suppliers to raise concerns on a 'confidential' basis and ensure adherence to the SCOP by the retailer. Other organizations such as Waitrose, which is not currently subject to the SCOP, operate an 'open door' policy giving suppliers access to their Chief Executive as an additional and secondary avenue of dispute resolution.

11.324 The grocery retailers that we propose should be covered by the GSCOP all have large buying teams. Even in retailers with exemplary compliance histories, and extensive internal training on the GSCOP, there will remain the possibility that a small number of buyers engage in behaviour from time to time that constitutes a breach of the GSCOP. In our view, the appointment of an in-house GSCOP compliance officer may allow retailers to detect such breaches themselves.

11.325 The in-house compliance officer should act as a point of contact for any authority or body making enquiries on GSCOP-related matters. This should, in itself, greatly assist the timely and consistent resolution of queries raised by suppliers, the Ombudsman or the OFT. Some retailers may also choose to use the compliance officer to obtain regular feedback from suppliers and make recommendations to the executive board on managing supplier relationships.

11.326 In order to enhance the effectiveness of the in-house code compliance officer, we decided that they should have a direct 'reporting line' to the chair of the audit committee of the retailer's board of directors.[1] We decided that the compliance officer should report to the audit committee (or non-executive director) as this would help to raise the visibility of compliance with the GSCOP at an appropriately high level within the retailer. In addition, the compliance officer must not sit within the commercial buying team, and must not have a reporting line to the management of the commercial buying team or anyone within that team. We consider this to be important in ensuring that GSCOP compliance issues benefit from a fresh pair of eyes from outside the team responsible for day-to-day relations with suppliers.

11.327 We decided that the report by the in-house code compliance officer must be included in the retailer's annual report.[2] This is consistent with a general trend, on the part of larger companies in particular, to include statements in annual reports on corporate responsibility, including supply chain relationships. In our view, to the extent that customers, and therefore the media, are interested in retailers' relationships with their suppliers, this will bring helpful additional pressure to bear on retailers to comply with the GSCOP and to treat their suppliers fairly. We noted that some UK grocery retailers already include such an item in their annual reports.

- *Record keeping*

11.328 We recognized that, currently, not all agreements with suppliers are recorded in writing, and that in many instances, especially in the category of fresh produce, key terms of agreements are agreed orally. We were concerned that the absence of written agreements may make it more difficult to establish whether terms of supply have been changed retrospectively. Therefore, in order to provide proof of retailers' compliance with the GSCOP, and to facilitate independent arbitration of disputes, we decided that the GSCOP shall include a requirement that the terms of supply between retailers and suppliers are recorded in writing, to enable proof of compliance with the provisions of the GSCOP, and to facilitate independent arbitration of disputes. In situations where it is usual commercial practice for key supply terms (for example, on price, quantity and product specifications and quality) to be agreed orally, a retailer will be required to confirm the terms in a subsequent email, fax or

[1] If a retailer covered by the GSCOP does not have an audit committee, the compliance officer should report to a non-executive director carrying out a similar function. If there is no executive director carrying out a similar function, this should be to the CEO or Managing Director.
[2] If the retailer does not publish an annual report, it should be required to publish an annual statement on its website.

letter to the supplier, or list the details of those terms on a restricted access web page available to the supplier.

♦ *Automatic provision of documentation*

11.329 Clause 1 of the existing SCOP (see Appendix 9.7) requires that the general and particular terms of business offered by a retailer be available in writing at the request of a supplier.

11.330 We decided that the GSCOP should oblige retailers automatically to provide their standard terms and conditions in writing to each of their suppliers of groceries before they enter into their first contract with that supplier, rather than simply making those terms and conditions available on request. In addition, at this time, a retailer must:

- inform suppliers of their ability to refuse a request;
- inform suppliers of their ability to escalate any buyer's decision to a more senior person in the commercial team for further consideration and given that person's contact details;
- inform suppliers of the identity and contact details of the in-house code compliance officer and the complaint mechanism;
- encourage suppliers to provide the in-house code compliance officer with feedback on the relationship with the commercial teams at the retailer; and
- inform suppliers that they cannot be de-listed for complaining, and that they will not be de-listed, or have their business with the retailer significantly reduced, for complaining, and that such action will not be taken by the retailer without the supplier reasonable notice in writing.[1]

11.331 In relation to de-listing, and concurrently with providing the written notice of de-listing, a retailer must:

- provide suppliers with a letter setting out the reasons for the retailer taking this action;
- give suppliers notice of their right to escalate a decision for de-listing or having their business with the grocery retailer significantly reduced, to a more senior person in the commercial team; and
- give suppliers an opportunity for an interview with the in-house code compliance officer prior to the decision taking effect.

Institutional arrangements for monitoring and enforcement

11.332 We have assessed in detail two options for monitoring and enforcement of the GSCOP:

- a GSCOP Ombudsman; and

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[1]Delisting in this context could include circumstances in which a supplier loses a significant amount of business.

- a combination of dispute resolution by an independent arbitrator, with monitoring conducted by the OFT.

Views of the parties

11.333 Many parties (the ACS, suppliers, supplier organizations, non-governmental organizations and primary producer organizations, and consumers) questioned whether the OFT was the best authority to supervise and enforce retailers' compliance with the SCOP, and, in addition, whether the monitoring authority should have a proactive role in reviewing retailer practices more generally. These submissions supported the establishment of an Ombudsman.

11.334 By contrast, many submissions from retailers supported the continued involvement of the OFT in this role. Morrisons said that the costs of an Ombudsman would be excessive, relative to the consumer detriment arising from supply chain practices. Certain retailers (Waitrose, Morrisons) suggested that the burden of the costs of the Ombudsman, should one be established, ought to be weighted towards retailers which are the subject of complaints and disputes. Our view of the proportionality of this remedy is discussed in paragraphs 11.420 to 11.422.

11.335 Some retailers (Asda, Waitrose) said that there was a danger of 'regulatory creep' (ie the Ombudsman extending its remit to non-competition issues). Waitrose said that if the Ombudsman were to have active investigatory powers and duties, these should be specified in detail to avoid expensive expansions of the Ombudsman's role.

11.336 The OFT recognized that a dedicated body with industry expertise, which would build working relationships with supplier trade associations and retailers and monitor compliance and promote best practice, would have advantages. It suggested that this entity could also raise the profile of the GSCOP and encourage best practice and monitor compliance. However, the OFT expressed reservations about the effectiveness of a remedy involving the creation of an Ombudsman. It was concerned that the creation of an Ombudsman would not fully address suppliers' fears of raising complaints, since dispute resolution would still require complainants to be identified.

Our views

11.337 We agree with the OFT that a dedicated body with industry expertise, which could build working relationships with suppliers, their trade associations and also with retailers, would be advantageous. We therefore decided that a GSCOP Ombudsman should be established to monitor and enforce the GSCOP, and to resolve disputes between retailers and suppliers under the GSCOP. One of our members dissented from this view (see paragraph 11.347).

11.338 In considering the role of the Ombudsman, we had regard to the role of the Office of the CRR Adjudicator.[1] As in the case of the CRR Adjudicator, and consistent with the statutory function of the OFT in monitoring ongoing compliance with market investigation remedies,[2] we decided that the Ombudsman should be appointed by the OFT. The Ombudsman would, however, be independent from the OFT and from all parties involved in any dispute. The OFT would set the Ombudsman's annual budget (with a

[1]The CRR Adjudicator monitors the 'contract rights renewal' remedy put in place following the CC's investigation into the merger of Carlton Communications plc and Granada plc.
[2]Section 162 of the Act.

contingency[1]), and would pay the Ombudsman's salary and expenses. These sums would then be recouped from the grocery retailers covered by the GSCOP, according to a predetermined formula. In response to submissions from Waitrose and CGL, we decided that, since the Ombudsman's activity will be driven to a large extent by complaints and disputes, it would be appropriate for the formula to take account of the number of complaints and disputes involving a retailer, as well as its UK groceries turnover.

11.339 The Ombudsman would have an overriding objective of monitoring and enforcing the GSCOP and thereby of promoting the long-run interests of consumers. Providing the Ombudsman with this express objective should address retailers' concerns regarding 'regulatory creep'. Although it is our intention that the Ombudsman should fully and effectively monitor and enforce the GSCOP, we do not seek any role for the GSCOP Ombudsman that goes beyond this. Moreover, we expect that the GSCOP Ombudsman will use its resources efficiently, focusing on those disputes and complaints concerning suppliers without market power over and above those concerning suppliers of major branded products.

11.340 The Ombudsman would report to the OFT on a regular basis (to be agreed between it and the OFT) regarding the nature of the complaints and disputes that it has investigated, and this report would be published on the Ombudsman's website.

11.341 The OFT would retain an overall supervisory role in relation to retailers' compliance with the GSCOP, in accordance with its duty to monitor market investigation remedies under section 162 of the Act. In this regard, grocery retailers will also be required to provide information to the OFT (and to allow the Ombudsman to pass such information directly to the OFT).

11.342 Given our observations on coordination in Section 8, we assessed the possibility that the Ombudsman might inadvertently facilitate or encourage coordination. It is our view that none of the provisions of the GSCOP will facilitate or encourage coordination, so that the Ombudsman, whose role will be confined to monitoring and enforcing the GSCOP, will not facilitate or encourage coordination. Further, we consider that the Ombudsman's role should explicitly exclude the undertaking of any activity that could facilitate or encourage coordination, such as round-table meetings, dissemination of best practice and the encouragement of any dialogue between suppliers and grocery retailers outside normal bilateral commercial arrangements.

11.343 Given the importance of involving stakeholders in the process of establishing an Ombudsman scheme, we will seek undertakings pursuant to section 159 of the Act from all retailers that we have decided should be covered by the GSCOP (listed in the footnote to paragraph 11.282). We recommend to BERR that, if undertakings are not offered by all retailers covered by the GSCOP and accepted by us, it should take the necessary steps to create an Ombudsman.

11.344 In the event that an Ombudsman is not established, either by means of undertakings offered by the retailers or as a result of steps taken by BERR, we will, as a 'fallback' option, order that the resolution of disputes under the GSCOP be performed by an independent arbitrator, nominated by an external body with expertise in alternative dispute resolution, such as CEDR.

[1]We consider the existence of a generous contingency fund to be important for the effectiveness of the Ombudsman. Without this, retailers may attempt to exhaust the Ombudsman's budget in the knowledge that it would be unable to function effective once this had been achieved.

11.345 Under this 'fallback option', the monitoring of retailers' compliance with the GSCOP would be performed by the OFT without assistance; we recommend to the OFT that if this option is implemented, its monitoring activities should be modelled on those proposed for the GSCOP Ombudsman (discussed in paragraphs 11.348 to 11.372).

11.346 In addition, under this 'fallback option', those retailers covered by the GSCOP would be required to have their compliance with the GSCOP certified by an independent audit, conducted periodically, with the audit report delivered to the OFT.

11.347 One of our members (Professor Lyons) dissented from the strong preference of other members to appoint an Ombudsman independent of the OFT. He supported the AEC finding that certain supply chain practices transfer excessive risks and unexpected costs to suppliers, with consequent adverse effects on investment and innovation incentives and therefore on the future welfare of consumers. He also supported the strengthening of the GSCOP, particularly with respect to coverage of grocery retailers, retrospective changes in terms and internal compliance measures. However, he believed that the Ombudsman would be counterproductive and strongly preferred rapid, independent arbitration of disputes combined with OFT compliance monitoring. In his view, the Ombudsman would not be able to preserve anonymity when dealing with complaints, and he was concerned that the German experience was also that complaint investigation revealed identities.[1] Given the limitations that we have identified in extending GSCOP vertically beyond intermediaries, he believed that the number of investigable complaints, as distinct from disputes that can be settled by an independent arbitrator, is likely to be limited. He was concerned that the Ombudsman may find a role 'proactively' representing the interests of suppliers, including global manufacturers and large intermediaries, which he considered would reduce the benefits of competition. He noted that the usual role of an ombudsman is to deal with complaints from ordinary citizens/consumers about public bodies or private sector suppliers, and that it is a qualitatively different and more difficult task to reverse this in order to deal with complaints from suppliers about their customers with a view to promoting the future welfare of final consumers. In his view, the OFT is well placed to refrain from undesirable intervention because it has an embedded mission to make markets work well for consumers. He believed that an 'independent' Ombudsman, however, would be susceptible to external pressures and regulatory creep. In addition, he was concerned that set-up and operating costs would be substantially higher for an independent Ombudsman than for the OFT.

Monitoring and enforcing the GSCOP

Views of the parties

11.348 Many suppliers have submitted that the current arrangements for monitoring and enforcement of the existing SCOP are inadequate. Suppliers explained that they were reluctant to use the dispute resolution process in the current SCOP (ie mediation by an independent mediator, appointed and paid for by the retailer, with the possibility of a complaint to the OFT if the dispute cannot be resolved), due to concerns about the independence of the mediation process and the likelihood of being de-listed by the retailers. Conversely, the retailers currently covered by the SCOP suggested that the lack of disputes is due to the effectiveness of the SCOP and their comprehensive dispute resolution procedures.

11.349 Moreover, suppliers told us that the OFT was not proactive in investigating disputes. Several parties suggested that an independent mediator, conciliator or arbitrator

[1]The experience of the BKA in dealing with supplier complaints is discussed in paragraph 2.23.

should hear disputes under the SCOP. It has also been suggested that an independent body should audit retailers' compliance with the SCOP on a more regular and detailed basis than the OFT currently does (for example, by taking confidential complaints from suppliers, which could provide market intelligence but do not necessarily result in disputes).

Our views

11.350 In our view, the effective monitoring and enforcing of the GSCOP requires both the resolution of disputes and proactive investigation of retailers' behaviour in respect of particular practices, sectors or types of supplier in order to identify whether breaches of the GSCOP have occurred. We think it is appropriate for individual suppliers to be able to use the GSCOP as a means of ensuring that specific disputes are resolved. However, we also believe that relying on such disputes as the basis for the monitoring and enforcement of the GSCOP would undermine its effectiveness as a remedy. This is because in order to resolve a dispute, the grocery retailer would need to be told the identity of the supplier bringing the dispute. We therefore believe that proactive investigation of practices by the body responsible for monitoring and enforcement will be critical to the success of the GSCOP. Such investigations will provide a basis for breaches of the GSCOP to be identified without revealing the identity of particular suppliers, and without the implication that any particular supplier has complained. We discuss the specific arrangements for dispute resolution and investigations below.

Dispute resolution

11.351 Under the SCOP, a retailer must offer the services of a mediator (at its own expense) 90 days after the dispute arises. However, the existing dispute resolution procedures under the SCOP are rarely invoked. More effective dispute resolution is a vital part of ensuring that the GSCOP operates successfully.

Views of the parties

11.352 The SCOP currently allows the retailers to choose mediators. However, a mediator appointed by the retailer is not seen by many suppliers as entirely independent.

11.353 Sainsbury's and Tesco both suggested to us that a shorter time-frame for initiation of the dispute resolution procedure under the GSCOP would make it more useful for suppliers, as they generally want quick decisions to reduce uncertainty associated with a dispute.

Our views

11.354 We decided that, if the same organization were to be used for all dispute resolution under the SCOP, it would allow expertise to grow, and would assist in bringing a greater degree of consistency in the approach taken to disputes under the GSCOP.

11.355 We considered whether there were aspects of the Australian Produce and Grocery Industry Code of Conduct (PGI Code) that may be worth incorporating in the GSCOP. Under the PGI Code, dispute resolution is coordinated by an independent ombudsman, who selects a mediator from a panel of approximately 40, all of whom are required to have a degree of industry knowledge. Experience of the Australian PGI Code also suggests that a single point for dispute resolution is beneficial, avoids the need to develop and maintain a degree of industry knowledge and ensures that any common or recurring practices within a retailer or across retailers are identified.

11.356 We considered the nature of the dispute resolution that should be conducted under the GSCOP. Currently, the SCOP provides for mediation, rather than arbitration.[1] However, we noted that there will often be a significant imbalance of power between the parties to disputes under the GSCOP, given our findings on retailers' buyer power. Mediation relies on parties negotiating resolutions to disputes, and it is reasonable to expect that a significant imbalance of power will undermine the effectiveness of such negotiations. We therefore decided that the enforcement of the GSCOP would be more effective if it provides for arbitration of disputes, rather than merely mediation.

11.357 We decided that a shorter time period for instigating the dispute resolution process (ie a reduction from the current 90 days) would improve suppliers' confidence in the effectiveness of the process. We therefore decided that either party (ie the retailer or the supplier) should be entitled to refer the case for arbitration 21 days after the notification of the dispute to the retailer pursuant to its internal dispute resolution processes. We note that this does not mean that any dispute will automatically be referred for arbitration 21 days after it was notified to the retailer. Indeed, if after 21 days the internal dispute resolution process was progressing well, the retailer and the supplier may prefer to pursue this process rather than refer the dispute for arbitration.

11.358 An Ombudsman will act as arbitrator in disputes between retailers and their suppliers, and publish guidance on interpretation of the GSCOP, for the benefit of retailers and their suppliers. We agree with Asda's suggestion that the Ombudsman should consult both retailers and suppliers on draft guidance before it is issued.

11.359 Paragraph 11.344 sets out the dispute resolution procedure in the event that an Ombudsman is not established. The 21-day period referred to in paragraph 11.357 for referring disputes to arbitration would also apply. The cost of this arbitration will be borne by the retailer concerned (although the arbitrator will be able to reverse this presumption if he or she considers that the supplier's claim is vexatious or totally without merit). We decided, however, that this presumption was necessary, given the current 'climate of fear' among suppliers in relation to disputes under the existing SCOP, to reduce the risk to the suppliers of bringing disputes and to encourage them to do so.

11.360 In the case of arbitration by either the Ombudsman or an independent expert, sections 67 to 69 of the Arbitration Act 1996 would provide limited rights of appeal to a court. However, parties will not have a right to appeal arbitration decisions of the Ombudsman to the OFT.

- *Information gathering and investigation of complaints*

11.361 As well as undertaking dispute resolution, we decided that the Ombudsman would also have the power to receive and, where appropriate, investigate complaints regarding breaches of the GSCOP. There is an important distinction between this function and the dispute resolution function outlined above. Where a dispute is notified to the Ombudsman, due process will require that a retailer has the opportunity to answer and address any particular allegations. A dispute will therefore necessarily concern specific allegations made by a specific supplier against a specific retailer.

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[1]We note that arbitration generally implies that an authority will make a decision for two disputing parties. This can be contrasted to mediation in which a third party assists the two disputing parties to come to a mutual resolution.

11.362 By contrast, we envisage that complaints could be received by the Ombudsman on a confidential basis, as a form of information-gathering. A single complaint may not result in any action other than its being collected and verified. Verification might involve meeting with the complainant to understand the scope of the complaint. Once the Ombudsman has sufficient information—for example, to spot a pattern of behaviour among retailers or areas of concern within a particular retailer's buying practices—it could open an investigation. The nature and scope of the investigation would reflect the area or areas of concern. It might concern a particular retailer or retailers' behaviour; a particular sector or sectors; or a particular period of time. It is important to note that where an investigation had been opened on the basis of complaints, the purpose of the investigation would be to understand the pattern of behaviour, not the individual complaints. On this basis, we do not consider that there would be any need to disclose the complainants that originated the investigation and they would be kept confidential from the retailer. By investigating areas of recurring concern, the Ombudsman would help build confidence in the operation of the groceries supply chain.

11.363 The complaints from primary producers that we reviewed suggested that it is not uncommon for processors and other intermediaries, in discussions with their suppliers (including primary producers), to attribute particular supply chain practices to direct intervention or pressure placed on the processor or intermediary by grocery retailers. We have also been told by grocery retailers that, in many cases, this attribution is incorrect, and that the supply chain practices are in fact instigated unilaterally by the processor or intermediary, with no input from the retailer. In order to increase the transparency with respect to supply chain practices, we decided that primary producers and other suppliers to intermediaries and processors should also be permitted to make complaints to the Ombudsman about alleged breaches of the GSCOP (ie retailers' conduct with respect to processors and intermediaries) where the primary producer or other supplier reasonably considers that the breach has had a direct or indirect effect on its interests. A number of retailers (Asda, Tesco) expressed concerns that providing non-contracting parties with a right to complain would lead to complaints being vexatious, or not based on a full and proper knowledge of the facts. We do not believe that the retailers' concerns are well-founded. We would expect that the Ombudsman, in response to a complaint from a third party, would contact the supplier against which the alleged breach of the SCOP had been committed, to corroborate the details of the complaint. Moreover, it should be noted that complaints, in and of themselves, will not lead to sanctions being imposed on a retailer.

11.364 In order to carry out investigations, the Ombudsman would require information-gathering powers. We decided that the grocery retailers should be under a requirement promptly to provide such information to the Ombudsman as it requires for the performance of its functions. Clearly, the record-keeping obligations discussed in paragraph 11.328 will also assist the Ombudsman in carrying out its functions. We would also expect suppliers to assist the Ombudsman with the provision of information.

11.365 In the course of undertaking investigations, the Ombudsman might also identify possible amendments to the GSCOP, and bring these to the attention of the OFT. The OFT would then need to assess whether to advise the CC that the GSCOP order should be amended accordingly. Otherwise, the Ombudsman will be limited to arbitrating and investigating matters covered by the GSCOP.

11.366 Once adverse and recurring behaviour is observed, the Ombudsman should consider launching an investigation, with a view to determining if it needs to be addressed. In addition to complaints, trends in a retailer's behaviour or behaviour in categories of groceries across a number of retailers might be obtained from:

- complaints from suppliers;
- recurring disputes involving a retailer;
- recurring complaints from retailers about another retailer's behaviour; and
- publicity surrounding a particular practice.

11.367 In regard to any investigation initiated from a number of complaints, anonymity would be a critical issue and it would be essential to ensure that individual complainants are not able to be identified during the course of an investigation or published reports. It is envisaged that the scope and timing of an investigation would be carefully selected to ensure that the identity of a particular supplier was not inadvertently disclosed.

11.368 If an Ombudsman is not established, the OFT would perform all the monitoring and enforcement functions associated with the GSCOP. We recommend to the OFT that, in the event that this option is invoked, its monitoring of retailers' compliance with the GSCOP should be extended, so that it undertakes functions similar to those sought for the Ombudsman:

(a) gathering information (for example, by receiving confidential complaints from suppliers and primary producers regarding breaches of the GSCOP) and proactively investigating retailers' records in areas subject to complaint, in order to identify whether breaches of the GSCOP have occurred;

(b) publishing guidance on specific provisions of the GSCOP where it considers that differences in interpretation exist; and

(c) reporting annually to the public on operation of the GSCOP.

The information-gathering powers discussed in paragraphs 11.361 to 11.364 for the Ombudsman will need to be granted to the OFT in the event that it is undertaking this monitoring function.

- *Penalties and compensation*

11.369 Under the existing SCOP, the main sanction for breach arises through section 167(4) of the Act, under which a supplier suffering loss or damage can bring proceedings against the retailer for breach of statutory duty.[1] In addition, the present SCOP includes limited provision for retailers to pay compensation to suppliers (eg for changes to supply chain procedures or specifications without reasonable notice, or erroneous forecasts—see SCOP, clauses 15 to 17 (see Appendix 9.7)).

11.370 We decided to incorporate the existing provisions of the SCOP for the payment of compensation by retailers into the GSCOP. However, we are not persuaded that the current provisions for the payment of compensation by retailers by themselves provide a sufficient incentive for retailers to comply with the SCOP or that they adequately reflect the effect that retailers' behaviour may have on suppliers. We are therefore keen to see the introduction of a more powerful compensation mechanism

[1]We note that the SCOP, being undertakings accepted under the Fair Trading Act 1973, are enforceable under section 167(4) pursuant to paragraph 15 of Schedule 24 of the Act.

into the GSCOP. To achieve this, we will also supplement these provisions with a formula in the GSCOP for calculating the amount of compensation or a stipulation as to liquidated damages, and allow the body undertaking arbitration of disputes under the GSCOP to award compensation/damages.

11.371 Under the present structure of the Act, the CC is unable either to impose penalties for breaches of orders or undertakings or to confer such a power on another body. Nevertheless, we concluded that a power to impose monetary penalties on retailers in respect of breaches of the SCOP would help to ensure their compliance. We recommend to BERR that, if it does not prove possible to secure undertakings from retailers in order to create the Ombudsman and BERR instead establishes the Ombudsman, then the Ombudsman should be given powers to impose monetary penalties on retailers in respect of breaches of the SCOP.

11.372 However, if the Ombudsman is given powers to order penalties, this should only be done where it has strong and convincing evidence that retailer has committed a breach of the SCOP. Any penalty decisions of the Ombudsman would need to be able to be capable of appeal to the OFT (and ultimately, to the High Court). In particular, it would not be appropriate for the Ombudsman to impose penalties based on anonymous complaints from suppliers or other third parties.

The GSCOP and coordination

11.373 In Section 8 we noted the recent activity of the OFT in respect of collusion in the groceries supply chain (paragraphs 8.4 to 8.9). We also observed a trend of consolidation among intermediaries and noted that increased concentration in the groceries supply chain may mean that collusion is more likely to emerge (paragraphs 8.10 and 8.12). We further noted that extensive use of category management might also bring about conditions which facilitate explicit coordination, including collusion between retailers, collusion between suppliers and collusion involving both retailer and suppliers (paragraphs 8.13 to 8.18). We gave particular thought to the question of whether the GSCOP and the Ombudsman were appropriate remedies in the light of these observations on coordination.

11.374 We noted that our finding that grocery retailers' supply chain practices resulted in an AEC stood regardless of our observations on coordination and we therefore thought that it remained important for us to achieve an effective remedy in relation to those practices. We consider that the changes we will make to the coverage of the GSCOP and the provisions it will include represent an effective and proportionate remedy and that nothing in the GSCOP itself will facilitate or encourage coordination.

11.375 Five of us consider that the Ombudsman is essential for the effective monitoring and enforcement of the GSCOP and therefore remain of the view that it is an appropriate remedy. We note that, as discussed in paragraph 11.337 et seq, we envisage a strictly limited role for the Ombudsman, confined to monitoring compliance with and enforcement of the provisions of the GSCOP. Since we do not see anything within the provisions of the GSCOP that will facilitate or encourage coordination, we do not see that the Ombudsman in performing his functions will facilitate or encourage coordination. Indeed, in specifying the role of the Ombudsman, we have explicitly proscribed activity that we consider may have stimulated coordination, such as round-table meetings, dissemination of best practice and the encouragement of dialogue between suppliers and grocery retailers outside normal bilateral commercial arrangements.

11.376 Overall, we do not consider that our observations on coordination change our view on the appropriateness of the GSCOP and the Ombudsman as remedies to the AEC we found in relation to supply chain practices.

Proportionality

11.377 In discussing each element of our package of remedies above, we have taken care to ensure that our chosen remedies represented the least-cost, least-intrusive package that would be effective in addressing each of the AECs we found. We are satisfied that our remedies to address the AEC we found in relation to highly concentrated local markets represent the least-cost, least-intrusive package that would be effective. Five of us are satisfied that our remedies to address the AEC we found in relation to the supply chain represent the least-cost, least-intrusive package that would be effective. As noted in paragraph 11.347, one of us did not support the establishment of an Ombudsman. We do not discuss this aspect of proportionality further in this section.

11.378 In the following paragraphs we assess the proportionality of our remedies in relation to highly-concentrated local markets (see paragraphs 11.379 to 11.398) and the groceries supply chain (see paragraphs 11.399 to 11.422).

Highly-concentrated local markets

11.379 In assessing the proportionality of the remedies we have chosen to address our AEC finding in relation to highly-concentrated local markets, we review:

- the scale of the adverse effect;
- the costs associated with each of the components of our package of remedies; and
- the scope of our chosen remedy.

Scale of adverse effect

11.380 We set out in paragraphs 10.13 to 10.17 our best estimate of the scale of the detrimental effect on consumers arising from highly-concentrated local markets. We estimate that the cumulative effect of weak local competition on store-level profit margins allows large grocery retailers to earn an additional £105–£125 million in profits per year at their larger grocery stores. This represents around 3 per cent of annual profits for the four largest grocery retailers. The additional store-level profits at mid-sized stores as a result of weak local competition may be of a similar order. Weaknesses in local competition also result in higher national prices than would otherwise be the case. The scale of the impact on national price levels arising from weak local competition, while difficult to measure, is potentially very substantial. For each 0.1 per cent increase in national price levels, consumer expenditure on groceries at the four largest grocery retailers increases by £80 million a year.

Costs associated with our chosen remedies

11.381 There are three components to our package of remedies to address our AEC finding in relation to highly-concentrated local markets. These are:

- the competition test;

- notification of store acquisitions; and
- measures in relation to restrictive covenants and exclusivity arrangements.

We set out below our assessment of the costs associated with each of these components.

Competition test

11.382 Based on information provided by the OFT and Tesco, we estimate the annual cost of the competition test remedy to be around £6–£8 million, consisting of costs to the OFT of £1–£2 million and costs to retailers of £5–£6 million. There is an element of judgement in this cost estimate as it depends on a range of variables, such as assumptions regarding the number of applications subject to the test and the likelihood of appeals. In the following paragraphs we set out how we have exercised our judgement in relation to the various assumptions and components underlying this cost estimate as well as in relation to other costs that we believe will either not be realized or should not be taken into account.

11.383 The OFT told us that its implementation costs would be £1.6 million a year.[1] This estimate included both the cost of the competition test and assessing whether restrictive covenants or exclusivity arrangements in highly-concentrated local markets should be lifted. This estimate is based on 180 planning applications a year (3.5 a week) and 20 requests a year for competition tests to be performed in relation to controlled landsites (200 in total). Based on a review of the number of planning applications in recent years, we believe that the OFT's assessment of an average of 3.5 applications a week is reasonable.[2]

11.384 Of these, the OFT assumed that there would be 40 cases each year requiring follow-up work (such as checking contested drive-times), and that each of these cases would take four person-weeks to resolve. The OFT also assumed that there would be ten applications annually for judicial review of its decision. Our view, however, is that the mechanistic nature of the competition test will not give rise to as many borderline cases as the OFT suggests. In particular, by specifying the software package and assumptions to be used for calculating isochrones, there will be little room for subjective judgement or dispute regarding the result. Nevertheless, for these purposes, we based our assessment on the OFT's own estimate of its likely costs.

11.385 Tesco submitted that the competition test would cost between £138 million and £184 million a year (see Table 11.2). The great majority of these costs comprise delay costs to retailers and consumers. In addition, Tesco's estimate included costs to LPAs of dealing with eight to ten appeals a year (£150,000 per appeal), retailer expenses arising from increased site research (£100,000 per retailer), OFT data requests (£500 to £1,000 per request), consulting and legal advice (£30,000 per application), appeal costs (£300,000 per appeal) and third party appeal costs (£100,000 per appeal).

[1] Tesco estimated that the OFT would incur annual costs of £2–£3 million but we consider that the OFT is in a better position to estimate its implementation costs.

[2] On average, 119 applications for new stores or extensions of stores larger than 1,000 sq metres were made annually by the four largest grocery retailers between 2000 and 2004. (We have excluded figures for 2005 as untypical for the period.) On the basis that these four retailers account for 1,741 of the 2,508 grocery retail stores operated by large grocery retailers in the UK in excess of 1,000 sq metres, this suggests that all large grocery retailers might have submitted in the region of 172 applications a year. This gives a figure of 3.3 applications a week. However, if retailers predict that a given development would fail the competition test, they may decide not to submit some of these applications. As a result, it may be that fewer than three applications a week will require assessment by the OFT under the competition test.

TABLE 11.2 **Tesco estimates for the cost of the competition test**

	Low scenario (3 applications per week)	High scenario (4 applications per week)
		£ million
LPA costs (excl OFT costs)	1.2	1.5
Retailers' expenses	9.5	12.0
Delay costs—retailers	90.0	120.0
Delay costs—customers	37.0	50.0
Total annual costs	137.7	183.5

Source: Tesco response to Provisional Decision on planning remedies.

11.386 The delay costs estimated by Tesco are based on an assumption that the competition test would, on average, add two weeks to the planning approval process, and that each appeal would take 12 months. The costs associated with each delay include lost profits from new stores (£[✂] a month), and increased travel costs for customers (based on travelling 5 minutes further to a store).

11.387 We do not, however, believe that the competition test will result in more time being required to consider planning applications. We recommended that the competition test be applied as part of the planning process with the OFT as a statutory consultee. All statutory consultees are approached at the same time in a planning application and we expect the OFT to respond within the 42-day statutory period, in common with other statutory consultees. As a result, the competition test should be applied within the usual overall timescale for considering planning applications. Moreover, we expect that the number of applications where the OFT would be the sole statutory consultee will be extremely small.[1]

11.388 Tesco also assumed that appeals arising from the competition test would delay store openings. As discussed in paragraph 11.122, we do not regard the scope for challenge as high, and we do not consider that the competition test will significantly increase the time taken for planning applications to be determined.

11.389 Tesco estimated retailer costs for the competition test at £9.5–£12 million a year (see paragraphs 11.385 to 11.386). We agree with Tesco that there will be some costs for retailers associated with the competition test. However, those proposing to develop sites, and retailers in particular, already research sites extensively and, given the nature of the test, the additional consulting and legal advice costs should not be as substantial as those suggested by Tesco. In particular, there is a limited amount of information that the retailer or third party will need to provide to the OFT, which may well be information that it would have as part of its planning application in any case. In the case of a grocery retailer, for example, we would expect the retailer to know before submitting an application the amount of groceries sales area it expected to create. The nature of the test means that it will generally be straightforward for a grocery retailer to determine whether a new store is likely to pass the test. We acknowledge that grocery retailers may face costs in complying with OFT information requests in relation to applications for store developments by other large grocery retailers or third parties. However, we believe that it would be a straightforward task for a store manager to calculate the groceries sales area of a store and that any

[1]We considered whether an LPA might take longer in determining an application where a retailer had failed the competition test and exceptional circumstances were considered. However, where exceptional circumstances are being considered (see paragraph 11.53), a planning application may take longer to determine in any event. As a result, we do not expect the competition test to lead to a delay in the planning process even where the application fails the competition test and exceptional circumstances are under consideration.

associated cost would not be great. Taking all this into account, we estimated a lower figure for retailer costs associated with the competition test (ie £5–£6 million) than that provided by Tesco.

Cost associated with notification of acquisitions remedy

11.390 While we do not have a precise estimate of the cost associated with our notifications remedy, we do not expect it to be costly to either grocery retailers or the OFT. The cost associated with the actual notification will be minimal. There may be additional costs associated with follow-up questions and with certain store acquisitions being subject to merger control scrutiny that might otherwise have been able to proceed due to the OFT not being aware of the transaction. However, we do not believe that these costs should be taken into account given that they are not incurred today as a result of the fact that an acquisition could escape appropriate scrutiny.

Cost associated with restrictive covenant and exclusivity arrangement remedies

11.391 There are three sub-elements to this remedy: *(a)* those relating to existing restrictive covenants and exclusivity arrangements that we have found act as a barrier to entry in highly-concentrated local markets; *(b)* those relating to the release of existing restrictive covenants and prohibition on enforcement of exclusivity arrangements where the OFT has identified the restrictive covenants or exclusivity arrangement as relating to a highly-concentrated local market; and *(c)* those relating to the use of restrictive covenants and the enforcement of exclusivity arrangements by large grocery retailers in the future.

11.392 We thought that the administrative costs to grocery retailers associated with this remedy were minimal. No grocery retailer has suggested otherwise. We have not taken into account any costs to grocery retailers in the form of lost revenues and profits arising from the lifting of a barrier to entry that results in new entry. These revenues represent an anti-competitive benefit for the parties, and the purpose of this remedy is to remove this benefit.

11.393 The costs to the OFT of applications for the lifting of restrictive covenants or exclusivity arrangements are set out in our discussion of the competition test (see paragraphs 11.383 and 11.384). Taking into account the process involved, the costs to the retailers of cooperating with this process, which we acknowledge may include answering some follow-up questions from the OFT (both in relation to restrictive covenants and exclusivity arrangements that involve them and those that involve other large grocery retailers), would be minimal.

Scope of the remedy compared with the AEC

11.394 Our remedies in relation to existing restrictive covenants and exclusivity arrangements that we have found act as barriers to entry in highly-concentrated local markets will apply only in those markets and will not extend beyond the areas affected by this AEC. This is also true of our competition test. We are therefore confident that neither the competition test nor our existing restrictive covenant and existing exclusivity arrangements remedies (both in relation to those identified by us in this inquiry and others not identified here) go further than is necessary to address the adverse effect on competition we have identified in certain highly-concentrated local markets.

11.395 Our remedies in relation to restricting the use of restrictive covenants and exclusivity arrangements in the future do go beyond existing highly-concentrated local markets and are not confined to those large grocery retailers that hold strong local market positions in such markets. However, this is because we do not regard it as practicable to target this measure only at large grocery retailers that have strong positions worth protecting in highly-concentrated local markets while maintaining the effectiveness of the remedy (see paragraphs 11.169 and 11.208).

11.396 Our remedy involving a requirement on large grocery retailers to notify acquisitions of trading stores in excess of 1,000 sq metres to the OFT (see paragraphs 11.123 and 11.124) will also apply beyond those areas that we have identified as highly concentrated. However, it is necessary for this remedy to extend beyond existing highly-concentrated local markets because it aims (in part) to prevent the emergence of new highly-concentrated local markets in the future.

Conclusion

11.397 The scale of the adverse effect arising from local market concentration is difficult to estimate. Nevertheless, we estimate that grocery retailers are earning additional profits from weak competition in highly-concentrated local markets of at least in the region of £105–£125 million, and probably significantly more when the effect on mid-sized grocery stores (with which larger grocery stores compete, as set out in our market definition—see paragraphs 4.135 to 4.146) and the impact of local concentration on national prices are also taken into account. Balanced against this, our estimates suggest that the likely cost of applying the competition test remedy will be in the region of £6–£8 million, while the costs of the controlled land remedies and the notification remedy will be very much lower. The package of remedies we have selected are targeted at the AEC and do not go further than is necessary to achieve an effective remedy.

11.398 Overall, we conclude that the competition test, the notification requirement, and the measures in relation to restrictive covenants and exclusivity arrangements are proportionate to the AEC that we found in relation to highly-concentrated local markets.

Supply chain remedies

11.399 In assessing the proportionality of the remedy we have chosen to address our AEC finding in relation to supply chain practices, we review:

- the scale of the adverse effect arising from these practices;
- the costs associated with our chosen remedy; and
- the scope of our chosen remedy.

Scale of adverse effect

11.400 As set out in paragraph 10.16, it is difficult to estimate the cost of investment and innovation in the supply chain that would not take place in the future if the conduct underlying our AEC finding were to be allowed to continue. However, the value of the groceries supply chain is of the order of £70 billion and even a small loss in investment and innovation, which would impact product quality and choice, will have a substantial detrimental impact on consumers.

Costs associated with our chosen remedy

11.401 There are two key elements associated with our chosen remedy in relation to supply chain practices. These are, first, the costs associated with the monitoring and enforcement of the GSCOP by the Ombudsman and/or the OFT, and second, costs that would be incurred by the grocery retailers covered by the GSCOP.

Costs associated with monitoring and enforcement by the Ombudsman

11.402 The OFT told us that it anticipated that the costs it would face in performing the functions envisaged by all remedies would be in the region of £2.5–£4 million. Given that the OFT told us that it expected the costs to it of performing its functions under the competition test (including the assessment of competition under the controlled land remedies) would be in the region of £1.6 million, this suggests a cost to the OFT of performing its functions in respect of the GSCOP in the region of £0.9–£2.4 million. The OFT told us that that estimate assumed the creation of an Ombudsman and included the cost the OFT would face in establishing the Ombudsman.

11.403 We expect the costs incurred by the Ombudsman to be met by the grocery retailers. Accordingly, this is discussed below.

Costs incurred by retailers

11.404 Tesco told us that its annual cost of compliance with the existing SCOP was approximately £[✂]. The single largest component was SCOP training at £[✂]. Tesco said that code compliance management time, including the time of its code compliance officer, was £[✂] (taking into account that his role includes other elements). Other costs of dealing with code compliance were those associated with answering queries. Tesco also told us that the cost to it of the OFT audit in 2005 was £[✂] although these costs were a conservative estimate of direct costs only and did not include any indirect costs or the costs of senior management time relating to the audit, which Tesco said were likely to be significant. Tesco told us that it had also faced one-off costs as a result of mediation and two complaints[1] in the region of £[✂].

11.405 Asda similarly estimated its annual cost of compliance with the existing SCOP as being in the region of [✂].

11.406 Sainsbury's told us that its estimated annual cost of compliance with the existing SCOP was approximately £[✂] a year, including £[✂] on training, £[✂] on internal audit compliance, £[✂] on external legal advice, £[✂] responding to disputes and £[✂] in responding to OFT audits.

11.407 Based on these figures, and using the highest of the annual compliance cost estimate provided to us, we have estimated that each retailer subject to the GSCOP would incur compliance costs of approximately £135,000 a year.

11.408 Under the chosen remedy, the Ombudsman will also be able to initiate inquiries based on supplier complaints. We estimate that the costs of such an inquiry to retailers might be similar to those incurred as a result of the OFT commissioned audits of the SCOP. Based on the cost estimates provided by Asda, Sainsbury's and Tesco, we estimate that these would cost a retailer approximately £120,000 a year.

[1]One of these complaints was dismissed by the OFT, and the other was not pursued.

11.409 We also worked on the basis that the costs associated with disputes, complaints and queries would double compared with those under the existing SCOP (although retailers will be able to minimize their compliance costs by abiding by the GSCOP) and added a further £33,000 a year (based on the [✂] estimate). Overall, this suggests total costs in the region of £290,000 a year for each grocery retailer covered by the GSCOP.

11.410 For some retailers, however, these costs may not be proportionate to the extent to which they contribute to our AEC finding. In particular, we set out in Section 9 that the ability to pass excessive risks and unexpected costs on to suppliers is a function of buyer power, and that buyer power is, in large part, a function of the size of the retailer. Given this, we decided that a threshold based on UK retail groceries turnover should be set, below which retailers will not be subject to the GSCOP.[1]

11.411 We decided that this threshold should be set at £1 billion a year. There is an element of judgement in the setting of this threshold in that it is not possible to calculate precisely the degree of buyer power that any individual retailer will have relative to its suppliers. Nevertheless, in setting this threshold, we also took into account the identity of the retailers where particular issues had been brought to our attention during the course of this investigation (see Appendix 9.9). There were very few cases which involved a grocery retailer with an annual turnover of less than £1 billion.

11.412 We thought about whether a higher threshold should be applied. If this was the case, we would be concerned that the GSCOP would not apply to retailers that we judge clearly have the ability to exercise buyer power, based on evidence of their conduct (see paragraphs 9.57 to 9.67). Given this, we were concerned that setting a turnover threshold higher than £1 billion for inclusion in the GSCOP would be inconsistent with our need to achieve as comprehensive a solution to the AEC and its detrimental effects on consumers of groceries as is reasonable and practicable.

11.413 On the basis that the GSCOP will apply to all grocery retailers who are members of a corporate group with an annual turnover in grocery retailing in the UK of at least £1 billion a year, 11 grocery retailers (Aldi, Asda, CGL, Lidl, Iceland, M&S, Morrisons, Sainsbury's, Somerfield, Tesco and Waitrose) would be subject to the GSCOP. Based on annual compliance costs of £290,000 a year (see paragraph 11.409), this suggests total retailer compliance costs of around £3 million a year. We estimate that upfront costs associated with implementing the GSCOP, such as training and re-drafting terms and conditions, are likely to be in the region of £1 million.[2]

11.414 For the four largest grocery retailers, not all of these costs will be additional given that they already incur compliance costs associated with the SCOP. Waitrose, which already has well-developed procedures for dealing with its suppliers, told us that establishing a whole new system to comply with the GSCOP would involve significant up-front cost). However, we consider that for those retailers that already have procedures for dealing with suppliers the additional costs arising from this remedy may be less than £290,000 and are likely to be significantly less.

[1]We considered alternative ways of determining this threshold. We looked at the use of a national groceries sales share figure. However, as well as being difficult to compute and open to debate, groceries sales shares reflect the size of a retailer relative to other retailers, rather than its size relative to suppliers (which, as discussed in paragraph 9.82, is more relevant to the question of whether the retailer has buyer power). A threshold based on the number of stores from which a company sells groceries would be comparatively simple to apply. However, the number of stores from which a retailer trades may not be a good proxy either for its overall size or its buyer power. For example, Asda has around one-third of the number of stores of Somerfield and yet has nearly three times Somerfield's annual turnover (see Appendix 3.1). In contrast, a threshold based on groceries turnover is a useful proxy for the size of a grocery retailer and therefore also its likely buyer power.
[2]This is based on the upfront training costs reported by Tesco on an annual basis, and the legal drafting costs reported by Asda on the introduction of the existing SCOP.

11.415 As noted above, we expect that the costs incurred by the Ombudsman will be met by those grocery retailers subject to the GSCOP. Given the role that we have specified for the Ombudsman (see paragraph 11.271) we consider that these costs will be driven very largely by the number of disputes and complaints brought against grocery retailers by their suppliers. To this extent we believe that these costs can be mitigated by the grocery retailers by ensuring that they comply with the GSCOP and work to resolve disputes in-house, rather than seeing them escalated to arbitration. There will be additional costs associated with the establishing and operation of the GSCOP Ombudsman that grocery retailers will not be able to mitigate by their compliance. However, noting that in our view the Ombudsman is an important element in securing the effectiveness of our supply practices remedy, we consider that this cost is proportionate to the AEC we found.

Scope of the remedy compared with the AEC

11.416 We note that our supply chain remedies build on the framework of the existing SCOP, extending it only to the extent needed to address the AEC finding. Where we have identified new provisions for inclusion in the GSCOP, they are targeted at addressing the problems we have found in respect of the transfer of excessive risk and unexpected costs, for example in relation to shrinkage and retrospective changes to terms and conditions of supply. The inclusion of the overarching fair-dealing provision was, in our view, the best way to balance the need to curtail unreasonable behaviour on the part of the retailers with the need to allow a measure of commercial flexibility; it allowed us, for example, to continue to permit grocery retailers to request changes to terms and conditions of supply.

11.417 We also noted the argument that by putting in place remedies restricting supply chain behaviour, we would risk preventing efficient contracts, which allocated risk and cost in an optimal way. However, we consider that the design of our GSCOP remedies substantially avoids this risk. We note that those measures that we decided to pursue in relation to retrospective changes to terms and conditions of supply still allow risk to be shared between grocery retailer and supplier provided agreement has been reached in advance. To the extent that this aspect of our remedy results in greater risk being borne by retailers, this will only be as a result of a lack of agreement from suppliers to accept greater risk, which addresses precisely the exercise of buyer power that forms the basis of our AEC.

11.418 We decided that the requirement for agreed terms and conditions of supply to be recorded in writing was essential if the compliance with the GSCOP was to be monitored and, therefore, if it was to be effective at all. Similarly, five of us believe that the Ombudsman will be very important in ensuring effective compliance monitoring and also in establishing confidence among suppliers in the GSCOP.

11.419 We are therefore confident that the measures that we identified as being effective in addressing the AEC we found in relation to supply chain practices and five of us believe that they do not go further than is necessary.

Conclusion

11.420 As we set out in paragraph 11.400, it is difficult to place a value on the cost of lost investment and innovation that would happen in the future. However, the value of the groceries supply chain of approximately £70 billion is such that even a small loss in investment and innovation is likely to have a significant detrimental impact on consumers.

11.421 We estimate that the total annual costs associated with this remedy excluding the costs incurred by the Ombudsman will be in the region of £3.9–£5.4 million (comprising £3 million retailer costs and £0.9–£2.4 million costs of the OFT). We also estimate that there may be a further £1 million costs incurred by retailers in the first year of operation of the GSCOP. There will be additional costs incurred by the Ombudsman, but we have not been able to assess the level of these costs as they will be driven largely by the number of disputes and complaints. However, for the same reason, we consider that these costs can be mitigated by the grocery retailers to the extent that they comply with the GSCOP. We conclude that the remedy is well-targeted to the AEC we have found, and addresses the transfer of excessive risk and unexpected cost to suppliers while not unduly restricting the retailers and while retaining scope for commercial flexibility.

11.422 Overall, taking all these factors into account, five of us conclude that the GSCOP, together with the Ombudsman, achieves as comprehensive a remedy to the supply chain AEC as is reasonable and practicable, and that it is proportionate to the supply chain AEC.

Relevant customer benefits

11.423 In deciding the question of remedies, the CC may 'in particular have regard to the effect of any [remedial] action on any relevant customer benefits of the feature or features of the market concerned'.[1] The CC will consider whether to modify the remedy that it might otherwise have imposed or recommended; however, the consideration of any relevant customer benefits does not involve weighing the benefits against the AEC and any detrimental effect on customers.[2]

11.424 If the CC is satisfied that there are relevant customer benefits deriving from a market feature that also has adverse effects on competition, when deciding whether to modify a remedy, the CC will consider a number of factors, including the size and nature of the expected benefit, how long the benefit is to be sustained, and the impact of the benefit on different customers.

11.425 We next consider relevant customer benefits for remedies relating to both local concentration (including the competition test, and controlled land remedies) and the supply chain in turn.

Local concentration

Competition test

11.426 Tesco claimed that there would be a detriment to consumers of another operator operating a store that would otherwise have been operated by Tesco and suggested that, depending which of Asda, Morrisons, Sainsbury's or Waitrose operated the store, the increase in prices at that store would range between £1 and £10 on a basket that would cost £100 in Tesco. We note that we have not found that Tesco has a particular cost advantage that cannot be replicated by other retailers or that Tesco always sets the lowest retail price. However, even if it were the case that a particular basket of goods cost less in Tesco than in other grocery retailers, the CC considers that a choice of fascia is a prerequisite of effective competition in a local market and that effective competition is the best means of ensuring that customers

[1]Section 134(7) of the Act.
[2]The CC's approach to the assessment of relevant customer benefits is discussed in more detail in *CC3*, *Market Investigation References*, paragraph 4.26 and following.

receive the price, quality, range and service that they want in the longer term. Although we accept that the competition test may result in sites that could otherwise have been Tesco stores—or any particular grocery retailer's stores—becoming stores of other grocery retailers, we do not accept that this will have a detrimental effect on customers.

11.427 None of the other grocery retailers made any representations in respect of relevant customer benefits. There were no concerns expressed by other grocery retailers with respect to relevant customer benefits.

11.428 As discussed in paragraph 7.35, we acknowledge that there are wider public benefits from the planning system, and we have taken account of these in considering the reasonableness of our competition test (see paragraph 11.48), although they are not in themselves relevant customer benefits.

11.429 Overall, we do not find that any relevant customer benefits will be adversely affected by the competition test.

Notification requirement

11.430 None of the parties has suggested to us that any relevant customer benefits would be jeopardized by the requirement on large grocery retailers to notify to the OFT their acquisitions of existing stores with net sales area in excess of 1,000 sq metres. Nor have we identified any. We therefore do not consider that any relevant customer benefits would be adversely affected by our notification remedy.

Restrictive covenants

11.431 We explored the question, raised in the 2000 investigation, of whether restrictive covenants could facilitate the creation of new and better stores. It should be noted that this would only constitute a relevant customer benefit where the new store would not have been created absent the restrictive covenant. It is not clear to us in relation to how many, if any, restrictive covenants this is the case. However, in any case, any such benefit would be offset in whole or in part by the adverse effect on competition in the local area resulting from the covenant. Overall, we do not think it is appropriate for us to modify our chosen remedy in order to preserve any such benefit.

Exclusivity arrangements

11.432 We have identified two possible relevant customer benefits that may result from exclusivity arrangements. The first is where they facilitate the new developments by ensuring the presence of an anchor tenant. However, it is important to note that the exclusivity arrangement would only constitute a relevant customer benefit if the anchor tenant would not otherwise have come into the development and if their absence would have resulted in a poorer retail offer at the development. The second possible relevant customer benefit from exclusivity arrangements is where they facilitate the entry of a store into an area where the store would not otherwise have opened. However, again, this would only be a relevant customer benefit where the store would not otherwise have opened.

11.433 It is not clear to us how many exclusivity arrangements have produced such benefits. However, we have already taken these possible benefits into account. We believe that time-limiting them in this way strikes the right balance between the need to facilitate development and the need not unduly to restrict competition, so that we should modify our chosen remedy in relation to exclusivity arrangements.

Supply chain

11.434 Notwithstanding the consumer detriment we expect will result if the supply chain practices we have identified as having an adverse effect on competition are left unchecked, we accept that it is possible that those practices have resulted in lower prices for consumers, at least in the short term. This could be seen as a relevant customer benefit and we examined whether our chosen supply chain remedies might jeopardize this benefit.

11.435 It might be argued that restricting the ability of retailers to adjust prices retrospectively for unforeseen events may increase costs that, in turn, might be passed on to consumers. However, we consider that this is an unlikely result given that the groceries supply chain is extremely sophisticated and capable of allocating risk prospectively and through the agreement of both parties. We anticipate that retailers and suppliers might consider including a formula in their specific terms of agreement that sets out the allocation of risks between retailer and supplier. Thus, the remedy does not rule out all modification of terms but it does provide a framework to make such renegotiation fair and efficient.

11.436 In any event, on balance, we judged that the GSCOP remedy, together with the Ombudsman, would result in benefits that, especially over the longer term, would outweigh these incidental negative effects on consumers. Having had regard to these possible relevant customer benefits, we therefore decided not to modify our chosen remedy.

Choice of remedies

Highly-concentrated local markets

Planning and the competition test

11.437 To address the AEC that we found in relation to local market concentration, we decided to recommend the following measures in order to establish the competition test within the planning system:

(a) that CLG and the devolved administrations take such steps as are necessary for the OFT to become a statutory consultee;

(b) that CLG and the devolved administrations take such steps as are necessary (including changes to the GDPO and its equivalents and to planning policy) to ensure that the OFT is consulted by LPAs on all planning applications for grocery store developments (including new stores and extensions, whether submitted by large grocery retailers or third parties including other grocery retailers) where the developed store will be in excess of 1,000 sq metres net sales area;

(c) that CLG and the devolved administrations take such steps as are necessary (including changes to planning policy) to ensure that where LPAs give open A1 planning permission that is not to be used for grocery retail, planning conditions are applied that limit groceries floorspace to less than 1,000 sq metres;

(d) that CLG and the devolved administrations take such steps as are necessary (including changes to the GDPO and its equivalents and to planning policy) to ensure that LPAs take account of the OFT's advice on the result of the competition test (see below) and that LPAs may only determine planning applications in a manner inconsistent with that advice where they are satisfied that:

(i) the particular development would produce identified benefits for the local area that would clearly substantially outweigh the detriment to local people from the area becoming or remaining highly concentrated in terms of grocery retailing; and

(ii) the development, or any similar development, would not take place without the involvement of a large grocery retailer that had failed the competition test (see below);

(e) that CLG and the devolved administrations take such steps as are necessary (including changes to guidance) to make clear that where LPAs determine planning applications in a manner inconsistent with the OFT's advice on the result of the competition test, they do so only when they have demonstrated on the basis of sound evidence that the criteria set out above have been satisfied and set out publicly the reasons for overriding the OFT's advice; and

(f) that CLG and the devolved administrations take such steps as are necessary (including changes to planning policy) to ensure that section 106 contributions in connection with matters unrelated to competition should not be considered by LPAs as sufficient to offset the effect the development would have on concentration in the local market.

11.438 We note that the introduction of the competition test into the planning system is contingent on action by CLG and the devolved administrations. We recommend to BERR that, if the competition test is not established within the planning system by CLG and the devolved administrations, it should consider taking steps to introduce the competition test outside the planning system.

11.439 In applying the competition test as part of the planning system, we recommend that the OFT provide advice on the result of the competition test to LPAs. In applying the competition test, we recommend that the OFT:

(a) assess concentration across an area defined using a 10-minute isochrone (calculated using a standard, readily available package such as MapInfo/Drivetime) around the store that is to be developed;

(b) count the number of fascias (including that of the retailer that might operate the developed store) operating large grocery retail stores within the isochrone, such fascias to include all full-range national or regional grocery retailers and symbol groups and independently-owned full-range grocery store operators;

(c) (where the number of such fascias is three or fewer) calculate the share of groceries floorspace within the isochrone that the grocery retailer operating the developed store would have after the development had been implemented, such calculation to include all full-range national or regional grocery retailers and symbol groups and independently-owned full-range grocery store operators;

(d) where a planning application was submitted by a large grocery retailer, provide advice to the LPA on whether that grocery retailer had passed or failed the test;

(e) where a planning application was submitted by a third party (including a grocery retailer that is not a large grocery retailer), provide advice to the LPA on which grocery retailers would fail the test;

(f) a particular retailer will pass the test for a particular local area (ie within a 10-minute isochrone around the store to be developed) if:

(i) it would operate the developed store as a new entrant in the local area;

(ii) the total number of fascias in the local area were four or more; or

(iii) the total number of fascias were three or fewer and the grocery retailer operating the developed store would have less than 60 per cent of groceries sales area in the local area (this decision taken on the basis of a majority of four to two); and

(g) a particular retailer would fail the test if:

(i) the grocery retailer was not a new entrant in the local area;

(ii) the total number of fascias in the local area were three or fewer; and

(iii) the retailer would have 60 per cent or more of groceries sales area (including the new store) in the local area (this decision taken on the basis of a majority of four to two).

11.440 In order to ensure the effective working of the competition test remedy, we will require all grocery retailers to provide to the OFT on request accurate figures for the groceries sales area of any store in the UK, and any other information that the OFT may require for the application of the competition test.

11.441 As a complement to our competition test remedy, we will also require large grocery retailers to notify to the OFT all acquisitions of existing stores of more than 1,000 sq metres.

Controlled land

11.442 To address the AEC we found arising from controlled landsites which act as a barrier to entry in a number of highly-concentrated local markets, we decided to implement the following remedies in respect of controlled land:

(a) In relation to the 30 restrictive covenants referred to in paragraph 7.113, the grocery retailer that benefits from each restrictive covenant in question must release the burdened land from the restrictive covenants by entering into a deed of release. In addition, that grocery retailer must make a full and proper application to the Land Registry to remove the restrictive covenants from the Charges Register. These steps must be taken within six months of the date of this report.

(b) In relation to existing restrictive covenants that were not referred to in paragraph 7.113, any large grocery retailer must release any restrictive covenant that relates to land in a highly-concentrated local market where it has a strong local market position, and which may restrict grocery retailing or have equivalent effect. Such restrictive covenants will be identified when:

(i) the owner of the burdened land applies to the OFT; and

(ii) the OFT applies the competition test (in a similar way as in relation to the planning remedies but adapted to apply to mid-sized as well as larger stores) and determines the area around the stores associated with the burdened land to be a highly concentrated local market and the grocery retailer benefiting from the restrictions as having a strong local market position.

(c) Large grocery retailers will be prohibited from imposing new restrictive covenants that may restrict grocery retailing or which have equivalent effect. Exceptions will be made to permit:

(i) restrictions in leases granted to tenants of residential dwellings which specify that a leasehold property is to be used only for residential purposes but they will not be permitted to burden the freehold title of land that they transfer with restrictive covenants which restrict grocery retailing; and

(ii) user clause in leases setting out the specific purpose for which land is to be used and which mirror section 106 obligations.

(d) In relation to the 30 existing exclusivity arrangements referred to in paragraph 7.113, large grocery retailers should not enforce or seek the enforcement by others of these exclusivity arrangements beyond a period of five years from the date of this report.

(e) In relation to any existing exclusivity arrangements not referred to in paragraph 7.113, a large grocery retailer must not enforce or seek the enforcement by others of any such exclusivity arrangement after the longer of (i) five years from the date of our report or (ii) five years from the date the grocery retail store was opened, where that arrangement relates to land in a highly-concentrated local market where it has a strong local market position, and which may restrict grocery retailing or have equivalent effect. Such exclusivity arrangements will be identified when:

(i) a person who agreed to give a grocery retailer exclusivity or any company wishing to develop a grocery retail store on the site covered by the exclusivity arrangement applies to the OFT; and

(ii) the OFT applies the competition test (in a similar way as in relation to the planning remedies but adapted to apply to mid-sized as well as larger stores) and determines the area around the store(s) associated with the land subject to exclusivity to be a highly-concentrated local market and the grocery retailer benefiting from the exclusivity as having a strong local market position.

(f) Large grocery retailers will be prohibited from enforcing or seeking the enforcement by others of new exclusivity arrangements once a period of five years from the opening of the grocery store to which the exclusivity arrangement relates has elapsed.

11.443 In addition to the above measures, which we will implement ourselves, we recommend to LPAs that if they receive applications for lifting existing restrictions imposed as a result of planning obligations or conditions, or if they are considering imposing planning conditions, or entering into section 106 agreements with grocery retailers in the future, they have regard to any adverse effects of the restriction on competition in reaching their decision. We also recommend to LPAs that if they are considering whether to enter into exclusivity arrangements in respect of grocery retailing in the future, they have regard to any adverse effects of the arrangement on competition in reaching their decision.

11.444 We further recommend to BERR that it amend the Land Agreements Exclusion Order so that exclusivity arrangements which restrict grocery retailing and which are entered into by grocery retailers which were previously within its scope should no longer benefit from exclusion from the Competition Act 1998.

Supply chain practices

11.445 To address the AEC we found in relation to supply chain practices, we decided to implement the following remedies establishing the GSCOP, based on the existing SCOP, but amended such that:

(a) all firms which are active in the supply of groceries at a retail level in the UK and which are controlled by corporate groups with, or which themselves have, annual UK retail groceries turnover of £1 billion or more;

(b) the existing formulation in respect of grocery retailers making 'requests' of suppliers remains but, as in the existing definition of 'Unreasonably Require' in the existing SCOP, the burden of proof will be placed on the retailer to demonstrate in all cases where a supplier has complied with a 'request' that it has 'genuinely volunteered' to do so;

(c) an overarching 'fair dealing' provision is included;

(d) an outright prohibition on suppliers being held liable for losses due to shrinkage is included;

(e) a provision that ensures that suppliers are less subject to customer complaint charges is included;

(f) retailers are prohibited from making retrospective adjustments to terms and conditions of supply;

(g) retailers must appoint an in-house code compliance officer who will report directly to the audit committee (or non-executive director) and whose report on compliance must be included in the retailer's annual report;

(h) retailers must keep written records of all agreements with suppliers on terms of supply;

(i) retailers must automatically provide their standard terms and conditions to a supplier in writing before they enter into their first contract with that supplier and, at the same time, must:

(i) inform suppliers of their ability to refuse a request;

(ii) inform suppliers of their ability to escalate any buyer's decision to a more senior person in the commercial team for further consideration and give that person's contact details;

(iii) inform suppliers of the identity and the contact details of the in-house code compliance officer and the complaint mechanism;

(iv) encourage suppliers to provide the in-house code compliance officer with feedback on the relationship with the commercial teams at the retailer; and

(v) inform suppliers that they cannot be de-listed, or have their business with the retailer significantly reduced, for complaining, and that such action will not be taken by the retailer without the supplier receiving reasonable notice in writing;

(j) if a retailer wishes to de-list a supplier or make a significant reduction in the supplier's business with the retailer, it must, concurrently with providing the written notice:

(i) provide the supplier with a letter setting out the reasons for the retailer taking this action;

(ii) give suppliers an opportunity for an interview with the in-house code compliance offer prior to the decision taking effect; and

(iii) give the supplier notice of its right to escalate decisions for de-listing or having their business with the retailer significantly reduced, to a more senior person within the commercial team;

(k) a retailer or a supplier may refer a dispute to arbitration 21 days after the dispute had been notified to the retailer pursuant to its internal dispute resolution processes;

(l) retailers must enter into binding arbitration, to be conducted by the Ombudsman if such is appointed, and otherwise by an independent recognized expert body (such as CEDR) to resolve any dispute with a supplier arising under the GSCOP;

(m) retailers are required to pay compensation or liquidated damages to suppliers for breaches of the GSCOP on the basis of a formula to be included in the GSCOP for the calculation of the amount of compensation or stipulation as to liquidated damages; and

(n) retailers are required to provide to the body monitoring and enforcing the GSCOP and investigating any complaints or resolving any disputes under it with any information it may reasonably require in pursuit of its functions.

11.446 In addition to the above remedies, we decided, by a majority of five to one, to seek undertakings from grocery retailers to establish a GSCOP Ombudsman to monitor and enforce compliance with the GSCOP, and who will:

(a) have an overriding objective of monitoring and enforcing the GSCOP;

(b) gather information (for example, by receiving confidential complaints from suppliers and primary producers regarding breaches of the GSCOP) and proactively investigate retailers' records in areas subject to complaint in order to identify whether breaches of the GSCOP have occurred;

(c) arbitrate disputes between retailers and suppliers arising under the GSCOP that are referred to it;

(d) publish guidance on specific provisions of the GSCOP where it considers that differences of interpretation exist;

(e) report to the OFT on a regular basis regarding the nature of the complaints and disputes it has investigated and publish this annual report; and

(f) not undertake any activity that could facilitate or encourage coordination among retailers or suppliers (such as round-table meetings, dissemination of best practice, and the encouragement of any dialogue between suppliers and grocery retailers outside normal bilateral commercial arrangements).

11.447 In addition, we recommend to BERR that if we do not obtain satisfactory undertakings from the retailers creating the GSCOP Ombudsman within a reasonable period, it should take such steps as are necessary to establish the Ombudsman. We further recommend that, if this is the case, BERR take steps to give the Ombudsman the power to levy significant monetary penalties on retailers for non-compliance with the GSCOP.

11.448 If neither we nor BERR are successful in establishing the Ombudsman within a reasonable period of time, the functions of the Ombudsman will be carried out by the OFT, with the exception of dispute resolution, which will be carried out by a recognized independent dispute resolution body (such as CEDR).

11.449 Although our terms of reference do not permit us to make any finding in this regard, and we are therefore unable to make a formal recommendation, we suggest that, if it subsequently appears that, despite the operation of the GSCOP (and the Ombudsman) intermediaries continue to transfer excessive risk and unexpected cost further up the supply chain, Defra and BERR should consider the introduction of appropriate measures, including the extension of the GSCOP and the role of the Ombudsman or the introduction of a similar, complementary code and arrangements to cover the intermediaries and primary producers.