16th March 2007

Tim Oyler Esq
Inquiry Secretary
Competition Commission
Victoria House
Southampton Row
London
WC1B 4AD

Dear Mr Oyler

Groceries market investigation – Emerging Thinking

1 Following the publication of the Emerging Thinking document on 23rd January, I am writing to comment on those aspects of the document that relate particularly to our members – brand manufacturers operating in the UK – and consumers.

2 The prevailing tone of the document presents an encouraging picture of the UK grocery market, with no major competition concerns arising at this stage of your investigation. While we would like to take heart from this, we fear such a picture is incorrect. Some elements may be a matter of interpretation – is the glass half full or half empty – but there are also instances where we believe the data is not robust, research has not delved sufficiently deeply, and where conclusions do not appear to be supported by the evidence given.

3 **Evidence and data**

The gathering of detailed evidence is obviously crucial to this investigation. It is vital in order to understand what is actually going on in this market. Furthermore, there are aspects of this market that are complex, not least the ways in which buyer power is acquired and exercised, and unless this is understood, the investigation will not only be superficial, its conclusions will be ill-founded and incorrect.

The Brands Group Limited
8 Henrietta Place London W1G 0NB
Telephone 07020 934250 Facsimile 07020 934252
Registered in England and Wales No 5660494
Registered Office as above

www.britishbrandsgroup.org.uk

4 Our concerns over the quality of the data and analysis evident in the Emerging Thinking relate to the shortage of primary data, the emphasis on behavioural rather than attitudinal data and the limitations of the GfK survey. We would make the following comments in particular:

5 - We note that much of the evidence relating to the health of the market and suppliers' issues is drawn from evidence relating to the food and drink sectors only, rather than all sectors defined as "groceries", including pet food, cleaning products, toiletries and household goods. For a market investigation of this importance, we hope that all product sectors falling under the definition of "groceries" will eventually be scrutinised.

6 - We detect a reliance on broad economic data that may well mask a more complicated picture. For example, a fall in the real cost of food of 7% since 2000 is referenced (para 9). This figure is unrecognisable to those suppliers we have consulted. Prices may have remained stable in the early years since 2000 as suppliers sought efficiencies (resulting in a decline in real terms after inflation) but in the past two years significant cost increases have resulted in real price increases The overall effect, I am advised, is that real prices in 2006 were more constant compared with 2000 than declining. This trend is reflected in The Grocer Price Index which shows a 2.7% rise in prices in the big four supermarkets between March 2006 and March 2007[1]. This is a somewhat different – and we suspect more accurate – picture than the Emerging Thinking would lead us to believe.

7 - *Margins*
Some broad statements in the Emerging Thinking do not seem to be supported by the evidence. An encouraging picture is presented of the viability of food and drink manufacturers, stating that "We have not identified an ongoing decline in margins or return on capital for this group of firms" (para 106). This conclusion however is contradicted by the evidence. In the Supply Chain Profitability working paper, 67% of GfK respondents claimed that gross margins had decreased over the last five years (para 11). In the case of branded suppliers the evidence suggests the tipping point has been reached, with operating margins showing a decline of 17% in the last two years for which there is evidence (2003 – 2005) and a decline in operating profit, with the trend being downwards (para 13).

8 - *Smaller branded companies and secondary products*
Of particular note is the OC&C data showing the margins of smaller branded companies (<£500 million) declining (Figure 4). This raises the issue of secondary brands (ie. those that are not the market leader in any category) which may be expected to come under particular pressure from both buyer power and the growth of own label. Indeed, the Buyer Power working paper confirms that own label has contributed to the increase in buyer power of UK retailers (para 7). The pressure on secondary brands may underlie the evidence in Figure 6 (Supply Chain Profitability working paper) which shows that returns on capital employed are around 40% lower for smaller brand manufacturers than for larger.

[1] The Grocer, 10 March 2007, p6

9 The significance of size has yet to be scrutinised by the Commission, again giving the impression that the analysis behind the Emerging Thinking is superficial. The fortunes of secondary brands warrant specific scrutiny as their role in the market has a direct bearing on competition. They are relevant to retail competition as they are particularly important for smaller retailers, so as secondary brands come under threat, smaller retailers are disadvantaged. As the economic viability of secondary brands is impaired due to falling distribution, so smaller retailers and their customers are deprived of an economic alternative. If secondary brands are replaced by own label in major retailers, as we suspect, consumers are less able to compare prices between retailers as different own label offers are not directly comparable in the way that branded products are. Nor can own label products always (or even often) be directly and readily compared with branded products. Furthermore, brands, including secondary brands, are more likely to invest in innovation than own label products which tend to compete primarily on price, resulting in an innovation loss to the market and reduced choice to consumers as they disappear. The essence of branding is consumer relevance via competitive innovation. This may underlie the GfK finding that larger suppliers are significantly more likely to say they are spending more on R&D than smaller companies (2.13.d). An inevitable corollary of declining volume is the inability to finance investment in R&D, which is part of the downward spiral leading to a reduction in inter-brand competition.

10 - *Innovation*

The Emerging Thinking places great store, rightly, on innovation, concluding that there has been no significant decline in R&D expenditure in recent years (para 119). We are encouraged that this is an area that you intend to scrutinise further as we believe this is a further example where the data cannot be taken at face value. The picture on innovation presented by GfK is of a market in which innovation is stable or declining (57% of respondents) and we are not as encouraged as you that 14% state they will be spending less on R&D than five years ago. This is particularly the case when the major reason for not spending more is the squeezing of margins / insufficient money to invest (77%), followed by insufficient returns on investment due to retail customers demanding low prices. These are worrying findings.

11 In gathering further evidence on innovation, we urge you to assess the relative trends for radical and incremental innovation respectively (incremental innovation being small changes just sufficient to stay ahead of own label or warrant a price change), along with trends in the cost of bringing new products to market. Furthermore, in a market where large retailers place an effective cap on suppliers' prices (resisting price increases) and new product formulations can be quickly replicated by retailers' own label products, conditions may well exist that result in wasteful innovation. It is essential to examine closely the pattern of R&D expenditure to ascertain the extent to which this varies between different markets, for example where there is vigorous competition between competing brands on the one hand and markets where the brand leader is the final rival to private label on the other.

12 Evidence in the GfK report hints at conditions where the drivers of innovation may concern maintaining margins and responding to copying, with retailers' resistance to paying more being the second most frequent reason for lower margins from some customers (para 2.11.a.iii), 23% of respondents stating that they spend more on R&D to

improve margins and 11% stating they spend less on R&D because there is insufficient return due to copy cat products (para 2.13.d). Retailer power may distort supplier R&D effort in different ways from an economic welfare perspective, in some instances resulting in under investment (where the copy cat threat is perceived as overwhelming) and in other cases in over investment (where the only way to tackle the copy cat threat is by constantly and otherwise needlessly changing product formulas and packaging). Just looking at average figures on R&D expenditure will miss this so it will be more telling to examine cases where R&D effort has declined or accelerated.

13 In concluding our assessment of the evidence and data presented in the Emerging Thinking document, the impression we have is of a superficial analysis – particularly when compared to the approach adopted in 2000 – and where only a catastrophic failure would be evidence that would convince the Commission that there are competition concerns in this market. Presumably the purpose of investigating the market now is to ensure that problems are identified and remedied before such a failure occurs. It is worrying that there seems a reluctance to gather detailed evidence and undertake depth analysis in order to fully understand the dynamics of this market.

14 There is an asymmetry in the market, where supermarkets are able to create and launch new products with ease but suppliers are unable to create new routes to market, shown by the fact that 84% of suppliers would find it difficult to replace those retailers from whom they receive the lowest margins (GfK, Chart 42). The trajectory is towards a tight retail oligopoly controlling consumers' access to grocery products and controlling suppliers' access to most consumers. Bearing in mind all these factors, this market warrants far closer scrutiny than that to which it has been subjected to so far, a point we return to. It has all the hallmarks of the Titanic tragedy where everything was serene above decks whilst the bridge failed to spot an iceberg, 90% of which was submerged.

15 **Buyer power**

Net net prices
We are convinced that your view that larger retailers do not systematically obtain lower prices from suppliers than smaller retailers and wholesalers is fundamentally incorrect (para 18). Not only would such a finding be at odds with the Commission's findings in 2000 and 2003, it is inconceivable that a large retailer would not seek – and use all its influence – to obtain better terms than any other retailer. Any objective analysis of grocery retailing shows that competitive advantage is gained through buying effectiveness since cost of goods account for 70% of sales value. It thus follows that a 1% buying advantage potentially translates into a 0.7% lower selling price. Of course, if this advantage were taken as profit, then profits would rise by around 14%.

Importance to retailers of buying effectiveness

	Financial structure	Effect of 1% better buying performance	
Retail selling price	100	100	
Retail buying price	70	69.3	= -1.0%
Gross margin	30	30.7	= +2.3%
Operating costs	25	25	
Net margin	5	5.7	= +14.0%

16 We believe your survey of 15 suppliers was flawed, as it failed to get to the heart of commercial relations between retailers and their suppliers. We see no evidence that the relationship between retail prices, suppliers' price lists, discounts for efficiencies (eg. logistics and payment terms), payments for retailer services, marketing investments and other payments, all of which make up the net net price, is fully understood.

17 *Must-stock brands*

The Buyer Power working paper discusses factors that mitigate against the buyer power of the big four supermarkets (para 8), with them stating that must-stock brands are difficult to replace. This fails to understand the reality of the situation. Retailers will stock major brands (Known Value Items) which are major because of continuing innovation that makes them highly relevant to consumer needs. Retailers require the visibility of these brands so it is not so much a question of retailers failing to stock, rather more a focus on cutting back the number of lines (SKU's[2]) stocked or seeking exclusivity.

18 The importance of must-stock brands in the balance of power with large retailers is also overstated in failing to take into account that a company's portfolio of brands is likely to include brands other than must-stock brands and that it will be constantly seeking to launch new brands which have yet to acquire any power in the market (see the last sentence of paragraph 2.454, 2000 Report). This point is also evident in the undertakings required of Coca-Cola by the European Commission (June 2005), forbidding the company to use its strongest brands to sell less popular products in its portfolio. Retailers will use suppliers' vulnerability on weaker products in their negotiations and in their exercise of power.

19 The Buyer Power working paper recognises that such changes as there have been since 2000 point towards increased buyer power, noting that the effect of own label and of increased sourcing on a national and international level potentially enhances buyer power. The debate about "must-stocks" is precisely where it was in 2000. Then the Commission rejected the supermarkets' argument, showing that suppliers are vastly more dependent on retailers than vice versa (paragraph 2.457, 2000 Report). Nothing has changed, giving the Commission no reason to reach a different conclusion than that reached seven years ago.

20 **Supply chain practices**

We are not surprised that more suppliers have not come forward with evidence of concerns relating to the behaviour of the large supermarkets. As we have discussed with you in this inquiry, with your colleagues in the Commission in previous inquiries and with staff at the OFT on numerous occasions, the prevailing climate of apprehension, the nature of the commercial relationships branded suppliers have with the major retailers and a prevailing scepticism that anything positive may result inhibits their coming forward. Nevertheless it is your duty to investigate this market thoroughly.

21 We note that your investigation of potentially problematic market practices has not been as thorough as it was in 2000, when 52 practices were identified and investigated individually. In the GfK survey, only 13 practices seem to have been surveyed (B13 / B32).

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[2] Stock Keeping Unit

22 We have raised concerns over “copycat” packaging of products, which mislead consumers over the reputation of the products and dupe some into making wrong purchases (Annex document, sections 6-7). The problem is particularly acute in the case of own label products as shoppers are unsure who makes them. They tend to realise that they are not made by the retailer whose name they carry and suspect them to be made by – and be the same as – the brand they copy. It has been suggested that it is not the Commission’s role to interfere with intellectual property (IP) rights. This is not the point. Where retailers have significant buyer power, legal remedies such as IP rights are ineffective as suppliers are unwilling to take legal action. The very fact that brand owners, even large multinationals, are so evidently reluctant to enforce their IP rights against retailers' copycat products is proof positive of their market power. A specific remedy is required to prevent those with buyer power misleading shoppers in this way.

23 We believe that the practices identified in 2000, and those that have occurred since, should be investigated individually to determine their impact on competition. Simply looking at suppliers’ overall investments as an indicator of their effect, as proposed in paragraph 123, is crude and inexact and is in stark contrast to the approach taken in 2000.

24 On the supply chain practices in the working paper, we have the following comments:

Exclusive dealing arrangements
In assessing the potential anti-competitive effects of EDAs, where these may involve branded products, we suggest that the impact of buyer power should also be taken into account. In the FMCG[3] market, suppliers will wish to see their products widely distributed in order to deliver the economies of scale that yield price competitiveness. If retail outlets are foreclosed to a supplier as a result of an EDA imposed by a retailer seeking to strengthen its differentiation, the supplier will be disadvantaged, competition between suppliers weakened and price competition between retailers impaired.

25 *Stocking of own-label products*
We are encouraged this will be investigated further.

26 In your analysis of the potential anti- and pro- competitive effects, we are surprised to see that “exclusionary behaviour from grocery retailers” was considered pro-competitive (para 67). Is this an error? We would have thought such behaviour would be considered anti-competitive. Furthermore, there are some aspects of own label products that may be detrimental to competition but are not included in your analysis, such as the inability of shoppers to compare prices of own label products between retailers (as they are not comparing like with like) and the reduced emphasis on innovation in own label products which tend to compete with the brand leader on the basis of price. It is also worth considering that the retailer in question controls the shelf space in store and is therefore in a position to give its own label products preferential shelf positioning and number of facings, both of which directly affect rates of sale.

[3] FMCG: Fast Moving Consumer Goods

27 The further analysis you intend to undertake focuses only on retailers' incentive and ability to foreclose access to their shelves to brands. In assessing the impact of own label products on competition, it would also be appropriate to seek evidence in the following areas:

- instances of excessive (wasteful) R&D as owners of leading brands invest in trivial innovations to stay ahead of own label, providing no benefit to consumers and wasting resources;
- instances where secondary brands have had to pull back investment in R&D;
- any decline in secondary brands and where they may have been weeded out in favour of own label;
- the limited ability of secondary brands to bring innovative ideas to market;
- delisting of branded product variants and pack sizes, thereby maintaining the presence of must-stock brands on shelf but reducing choice.

28 Were competition concerns to be found in this area, we believe there are remedies available that would address the problems while safeguarding the pro-competitive aspects listed in the working paper.

29 *Recommended Retail Prices*

The analysis of RRPs focuses almost exclusively on the potential anti-competitive effects. Under potential pro-competitive effects, there is no mention of the potential role of RRPs in increasing *inter-brand* competition. This is surprising bearing in mind the debate taking place before the US Supreme Court concerning the more hard core r*etail price maintenance* (cf. the Leegin case). There is scope here for a more thorough and balanced analysis. (See *Thirty years prohibition of resale price maintenance – Germany on the verge of change*, Dr Doris Hildebrand, ECLR, Issue 4, 2005 and *The impact of private labels on welfare and competition – how retailers take advantage of the prohibition of resale price maintenance in European Competition Law*, Rainer Olbrich and Carl-Christian Buhr, 2004 Research Paper, Hagen University.)

30 **Harm to consumers**

The Emerging Thinking document does not explore comprehensively the various ways in which consumer harm may arise in the grocery market or the specific needs of various groups of consumers and the extent to which these needs are or are not currently met.

31 Consumer welfare of course raises much wider concerns than price, with variety and choice also being critical. The consumer welfare issues, and especially the impact on disadvantaged consumers, were raised in the 2000 Report (paragraph 2.390), where the Commission balanced the benefits for some consumers of lower pricing against the detriments for other consumers in terms of access, amenity and choice. In the case of retailing, particularly in a market where the number of convenience stores is declining, reducing the very convenience they are designed to deliver, accessibility and amenity are important considerations.

32 We do not detect the same rigour in understanding consumer / shopper behaviour as was the case in the 2000 report where a research study was commissioned into the subject. This is disappointing as a repeat of the 2000 study, using the same methodology, would provide a unique insight into changes in the way people shop and, as a result, may yield important insights into the way the market has developed.

33 This however will not go far enough as consumer behaviour is constrained by the existing shopping environment and choices they face today. The consumer research study proposed above would fall short in providing insights into underlying consumer needs and the extent to which today's grocery market meets those needs. Further work in this area is essential to understand whether this market really is working for the needs of consumers fragmented into different social groups. What are the trade offs that different consumers in different parts of the country make and what are the perceived consumer costs and benefits of the current grocery market? The expansion of multiple grocers and lifestyle changes have historically contributed to a decline in specialist retailers. However there has been little attempt to examine more recent changes in lifestyle, income distribution and demographics. Such changes may have a significant effect on consumer needs. To the extent that entry barriers have increased due to the vertical integration of the multiple chains, the withering of specialist wholesalers or the predatory behaviour of the multiples, then a market response to changing consumer needs is slow or imperfect. This would represent a diminution of welfare. We suggest the Commission investigates this.

34 **Concluding comments**

In the Commission's press release of 23rd January, the Chairman stated that the first job has been "to obtain and present the facts objectively". As you will have gathered from our response here, we question whether some of the facts obtained can be relied upon, whether all the necessary facts have actually been obtained, and whether some of the facts have been interpreted correctly. We are struck by the contrast in the thoroughness of the 2000 market investigation with this one, while recognising that the Emerging Thinking is not a final report.

35 We urge further detailed analysis. Bought in products account for 70% of the sales value of grocery retailing, a far higher percentage than in many other industries. Negotiations with their suppliers are the essence of each grocer's competitive performance. These negotiations relate to both price and cost savings within the retailer. It follows that the precise form of commercial negotiations varies between each retailer with each supplier. It is therefore not sufficient to rely on broad industry statistics to probe the operation of this market. It is necessary to probe how each retailer purchases from each supplier as was undertaken in 2000. Further, a similarly comprehensive analysis in 2007 would identify the extent to which buying effectiveness has been influenced by changes in market share.

36 We are conscious both from our discussions with the Commission and from the Emerging Thinking of a mantra emerging that, unless suppliers come forward, there is nothing the Commission can do. We find such a passive approach surprising and worrying in light of the market being investigated. The "climate of apprehension" that prevails was clearly identified as a feature of this market on two previous occasions and needs to be taken into account in the methodology of this investigation.

37 We also believe it would be instructive for the Commission to look at other national markets where retail concentration is high, to detect whether these markets provoke a similar strength of protest that we see in the UK. We suggest the following countries for such a comparison:

- Sweden, where the top 3 retailers command 83.5%[4] of the market but they are not as vertically integrated as UK supermarkets, with each store having a degree of autonomy over stocking and promotional policies;
- Germany, where the top 5 retailers command 69.8% of the market but where there is less out-of-town development than in the UK;
- Australia, where the top 2 retailers command 76% of the market[5], but where there is a vigorous wholesale sector supporting vibrant independent retailers;
- Canada, where the 5 top retailers command 90% of the market[6], but where Loblaws, the market leader, has a wholesaling arm that supplies independents.

Where we believe the UK differs from these – and other – markets is that the big four UK supermarkets possess not only significant downstream power but also significant upstream power. The former, we contend, is reinforced by (1) the vertical integration of the major chains, with their close alignment between warehousing and retailing as they practise 'just-in-time' replenishment and carry minimal inventories, resulting in no prospect of rivalry within the same chain (in contrast to a non-integrated chain with independent retail members) and (2) the extent of local market power in the UK (where competing stores are relatively few in number and tend to be located some distance from each other, allowing for geographic segmentation and making it harder for consumers to shop around and switch stores). Thus power in the downstream market is inter-related to power in the upstream, a linkage that has a multiplier effect.

38 We are of course willing to discuss any aspect of this letter with you in further detail, should this be helpful. Our last plea is that sufficient time is given to scrutinise this market thoroughly to ensure that the conclusions reached are correct. We will all be living with the consequences for many years to come and therefore wish to see an investigation based on accurate evidence and robust analysis.

Yours sincerely

John Noble

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[4] M&M Planet Retail, 2002

[5] *Australia's retail food sector - Some preliminary observations*, Andrew Jacenko and Don Gunasekera, Australian Bureau of Agricultural and Resource Economics, May 2005

[6] Conference Board of Canada, 2005