



4th September 2007

Tim Oyler Esq
Inquiry Secretary (Groceries market inquiry)
Competition Commission
Victoria House
Southampton Row
London
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Dear Mr Oyler

Groceries market investigation – Working papers on supplier pricing and the waterbed effect

- 1 Following the publication of the Working papers on supplier pricing and on the waterbed effect, we are writing to comment on those aspects of the two documents that relate to our members – brand manufacturers in the UK – and consumers. We take each working paper in turn.

- 2 **Supplier pricing to grocery retailers and wholesalers**

We support the detailed analysis of supplier pricing by the Competition Commission (CC) for the indication it gives of the extent of buyer power in this market (and therefore the potential for abuses of buyer power). It will however only give this indication if the analysis is thorough and robust. As you are aware, we felt that the initial findings in Emerging Thinking were incorrect.

- 3 In reviewing the working paper we are struck by three particular issues:
 - the paper looks at the relationship between volume and price, but does not analyse the relative costs of suppliers and the extent to which these rise and fall in relation to volumes / efficiencies;
 - the paper does not analyse the extent to which promotional and discretionary monies paid to retailers are dependent on the size of that retailer;

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- while the paper refers to promotional and marketing monies paid by suppliers to retailers, we are not clear that all payments have been taken into account.
- 4 The relationship between suppliers' costs, volumes and prices is of course critical to a full understanding of the extent to which buyer power is exercised in this market. We do not have cost data ourselves or know how dependent those costs are on volumes, this being confidential to individual companies.
- 5 We urge the CC to fill in this vital missing cost element of its analysis of supplier pricing by finding out the differences in cost of supplying different volumes to retailers of different sizes, so that these can be compared with the different supplier prices that are in fact negotiated. This will indicate whether, and the extent to which, buyer power may extend beyond cost-justified discounts.
- 6 The second reason why net net prices may vary between retailers is the payment of marketing monies by suppliers to retailers. While recognising that such payments are made, the working paper does not explore the extent to which such monies are cost justified. If marketing monies are paid to maintain distribution, and suppliers pay more to larger retailers as a result, this would be important to an understanding of why net net prices differ. In other words, is size is a key reason for price differences and is the route to those differences through suppliers' marketing expenditure budgets?
- 7 While the working paper refers to logistics efficiencies and marketing monies, we have not found an analysis of other benefits that one retailer may be able to negotiate over another. The CC's analysis of supply chain practices is directly relevant to its analysis of net net pricing, identifying those practices that may pass costs to suppliers and improve a retailers' profitability *vis a vis* its retail competitors.
- 8 These observations suggest that the working paper may under-estimate the differences in net net terms between very large and smaller retailers, and therefore the extent to which cost differentials make it difficult for smaller retailers to compete.
- 9 **The waterbed effect working paper**

We are surprised that the CC has not found evidence of a waterbed effect in this market, defined in its broadest sense (ie. do large retailers extract disproportionately better terms from suppliers and, if so, do smaller retailers end up paying more). We do not believe, for example, that such an effect would be the result of any deliberate policy by suppliers – we believe suppliers will seek to support all their distribution channels as far as they are able. However, if large retailers use their scale to extract better terms from suppliers, suppliers will charge relatively higher prices where they can, including to smaller retailers, or carry the cost themselves with implications for their own investments and competitiveness.
- 10 We are struck by the fact that the working paper is more a critique of a specific economic model, rather than a practical examination, based on core data, of whether large retailers obtain disproportionately better terms and, if they do, whether smaller retailers as a result obtain worse terms. We believe the emphasis of any analysis should be firmly on the latter.

- 11 There are two primary ways in which we believe a waterbed effect may operate. Firstly, suppliers tend to run their businesses on total profitability rather than account profitability, so were a Finance Director to see profitability sagging, he would call for a general (rate card) price increase to all retail customers. Were large retail customers to resist and delay implementation of such an increase but smaller retailers to pay it, a waterbed effect would be created which would become further exacerbated over time as each price increase from the supplier is negotiated.
- 12 Secondly promotional monies account for as much as 20% of sales value, and if large retail customers obtain a disproportionate share of such monies, this would contribute to a waterbed effect to the detriment of other retail customers outside the supermarket channel. We would expect the waterbed effect, if it exists, to be most pronounced across trade channels rather than between major supermarkets because price is so important in the supermarket trade channel but, in the convenience channel for example, other consumer factors come more into play such as shop proximity, opening hours and urgent consumer purchases.
- 13 In determining the presence of a waterbed effect in this market, and its extent, we suggest the CC assesses whether specific features consistent with a waterbed effect are or are not present. Some of the features which we believe may indicate a waterbed effect in this market are:
- large retailers pay less for their goods than small retailers;
 - increasing market share allows a retailer to obtain increasing discounts, with the reverse if a declining market share;
 - large retailers receive proportionately more promotional and other support from suppliers than small retailers;
 - large retailers grow faster on a like-for-like (ie. sales per sq foot) basis than small retailers;
 - large retailers open proportionately more new stores (ie. new build, not acquisition) than small retailers;
 - large retailers undertake proportionately more expenditure on improving their retail offer by (i) increasing spend on store refurbishment, (ii) increasing spend on store expansion, (iii) increasing spend on in-store amenities, and (iv) increasing proportionately more new/additional product lines, than do small retailers;
 - the retail price gap between big, medium and small retailers in a relative sense increases over time;
 - retail concentration increases over time;
 - small and some medium-sized retailers exit the market;
 - independent retailers become affiliated to symbol groups in order to obtain lower supply prices and more promotional support (from having a consistent retail identity);
 - supplier concentration increases over time.

An analysis of these features would indicate whether waterbed effects are unlikely, possible or very likely.

- 14 The working paper assesses the respective relevance of price-based as opposed to lump sum negotiations between suppliers and retailers (paras 34 – 39), suggesting that the presence of lump sum payments undermines the economic model being scrutinised. Whether this is or is not the case in respect of the model, the significant presence of lump sum payments does not indicate that waterbed effects are not occurring.
- 15 Waterbed effects can persist with lump sum discounts because large retailers appreciate that any form of discount can be put back into their business to improve the retail offer in ways not related to price (eg. improved store amenity, increased sales area, product availability (logistics), etc). In other words, lump sum discounts obtained from suppliers still allow large retailers to improve their retail offer relative to small retailers.
- 16 We believe that only the CC can undertake an analysis into the waterbed effect. While we note interventions from Tesco and Sainsbury's, and the economic model provided by the ACS with the support of its advisers, the evidence for waterbed effects can only rest within suppliers. Retailers and consultancies simply do not have the necessary complete insight into suppliers' financial control procedures to assess waterbed effects. It must be for the CC to probe the mechanisms by which suppliers determine prices, trade terms and promotional monies.

17 **Conclusion**

We welcome the CC's desire to analyse in detail the nature of, and influences on, supplier pricing as we consider such an analysis to be important to the understanding of buyer power in this market and whether or not this market is working well for consumers. The consumer research we have submitted ("*Are consumer needs being met?*") suggests that large numbers of consumers are having to make significant trade offs due to the decline in independent and specialist stores, yet many specialist stores are exiting the market. Should waterbed effects contribute to these exits and present a barrier to entry by inhibiting new retailers' access to products at competitive wholesale prices, then consumer detriment will clearly occur.

- 18 Please let us know if we can provide any further information or background on these thoughts on supplier pricing and waterbed effects.

Yours sincerely



John Noble