

# **Economic Note on UK Grocery Retailing**

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## Economic Note on UK Grocery Retailing

1. UK grocery retailing is dominated by large multiple 'supermarket' chains. Their size, visibility and influence have made them the focus of much attention and even controversy. Drawing upon industry data and specialist literature this note:
  - provides a brief **economic overview** of the sector
  - outlines some **key trends** and **characteristics** of the sector
  - explores the **nature of competition** between food retailers
  - considers the **economic, social and environmental impacts** of the rise of supermarkets.
  
2. This note draws heavily upon the following sources:
  - Competition Commission, *Supermarkets: a report on the supply of groceries from multiple stores in the United Kingdom* (2000)
  - Cooper, D., 'Findings from the Competition Commission's inquiry into Supermarkets', *Journal of Agricultural Economics* (March 2003)
  - Dobson, P. et al, 'The Patterns and Implications of Increasing Concentration in European Food Retailing', *Journal of Agricultural Economics* (March 2003)
  - IGD, *Grocery Retailing 2005* (August 2005)
  - IGD, *European Grocery Retailing* (June 2005)
  - Institute of Fiscal Studies (IFS), *Retail Productivity* (December 2004)
  - OFT Research paper (London Economics), *Competition in retailing* (1997)
  - OFT, *The grocery Market: The OFT's reasons for making a reference to the Competition Commission* (2006)<sup>1</sup>
  - Oxford Institute of Retail Management (OXIRM), *Assessing the productivity of the UK retail sector* (2004)<sup>2</sup>
  - Seth, A. and Randall, G., *The grocers: the rise and rise of the supermarket chains* (1999)
  
3. Underlined terms (when first appearing) in the paper are explained in the Glossary at the end of this paper.

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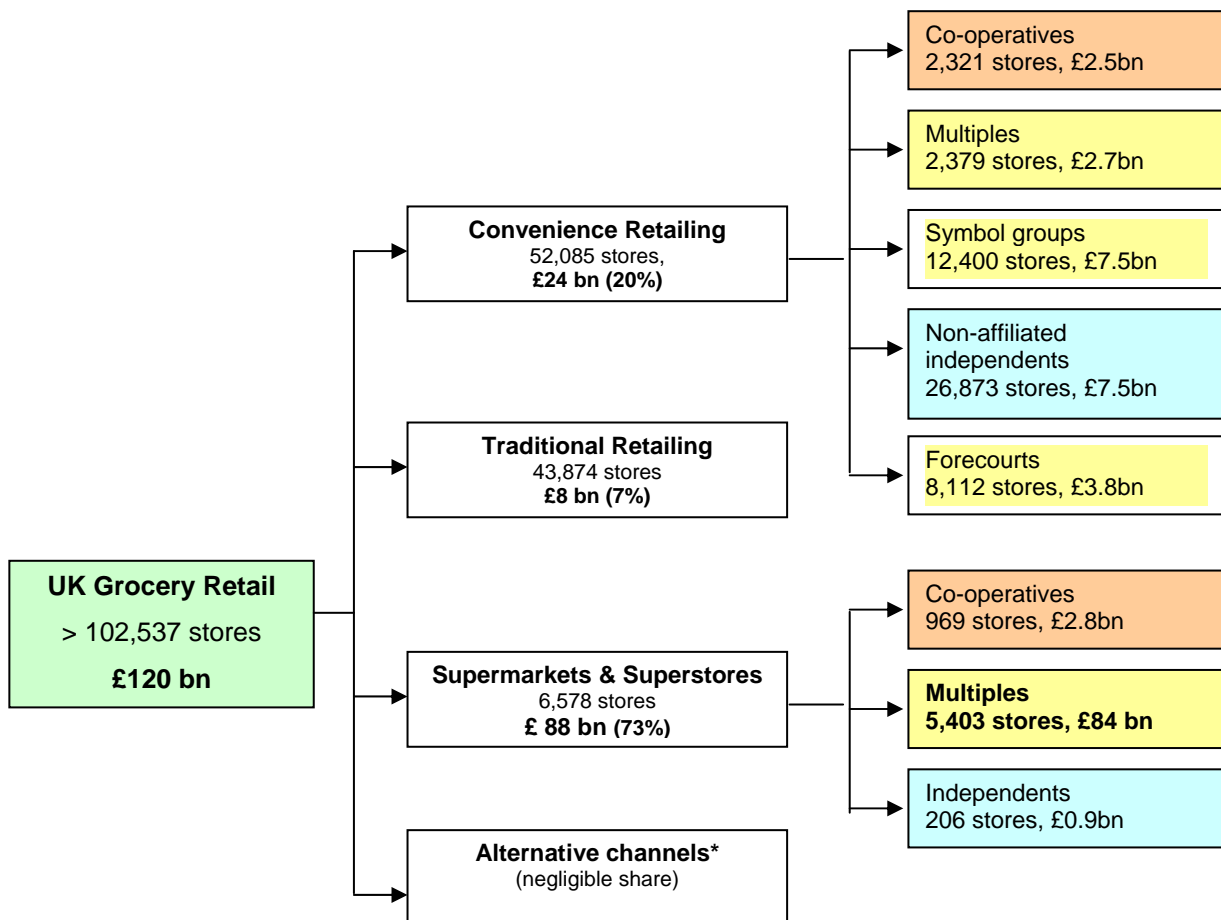
<sup>1</sup> Available at <http://www.offt.gov.uk/NR/rdonlyres/1A2D7FA2-FEA3-4459-9B25-4A737A20023D/0/oft845.pdf>

<sup>2</sup> Available at <http://www.dti.gov.uk/retaildoc/productivity.pdf>

## ECONOMIC OVERVIEW OF GROCERY RETAILING

4. Figure 1 summarises the structure of UK Grocery Retailing. The IGD<sup>3</sup> values retail sales through UK grocery outlets at £120 bn in 2005, a 4.2% increase on 2004. Table 1 provides breakdown by category.

**Figure 1 Breakdown of the UK Grocery Market by Value (£bn)**



source: IGD Grocery Retailing 2005

\* these include retailers selling food and groceries not normally considered as grocery outlets, e.g. chemists, kiosks, box schemes, retail and farmers' markets, as well as anticipated future channels such as home shopping.

<sup>3</sup> Market intelligence experts, formerly known as the Institute of Grocery Distribution.

**Table 1 UK Grocery Retail Sales by Category, 2005**

	value	%
food and drink	£ 78 bn	65 %
tobacco	£ 12 bn	10 %
non-food grocery	£ 17 bn	14 %
non-grocery	£ 12 bn	10 %
<b>Total retail sales through UK grocery outlets</b>	<b>£ 120 bn</b>	

source: IGD Grocery Retailing 2005

5. Sales of *food and drink* account for 65% of the total. *Non-food grocery* and *non-grocery* sales are becoming increasingly important. *Non-food groceries* are traditional grocery items like toothpaste, soap, health and beauty products. *Non-groceries* include electrical goods, fuel and housewares.<sup>4</sup>
6. About  $\frac{3}{4}$  of sales are made in supermarkets and superstores. The majority of the remainder is accounted for by convenience retailing, with traditional small retailers<sup>5</sup> now accounting for only 7% of sales.
7. Sales through UK grocery outlets of £120 bn represent almost half of all retail sales, (valued at £246 bn at the end of 2004 (ONS)), and 13.1 % of total household expenditure.
8. **Gross Value Added** (GVA)<sup>6</sup> of the *food and drink* retailing sector was measured as **£20.1 bn** in 2004, or 2 % of total UK Gross Value Added. This was slightly less than the *food and drink manufacturing* sector (£21.3 bn) and the *non-residential catering* sector (£21.8 bn) but significantly larger than the *food and drink wholesaling* sector (£7.5 bn). GVA of the food chain (beyond the farm gate) totalled £70.6 bn in 2004.
9. **Employment** in food and drink retailing exceeded 1.2 million in December 2005 – almost 5 % of UK employees. Over 60 % of employees were part-time or female (45 % were both part-time and female).
10. Around 55,900 businesses in 2004 (ONS), with about 102,500 stores are classified as mainly or specialised food and drink retailers.
11. **Profit margins** of the main supermarkets ranged between 2% and 6 % in 2004/5 (see Figure 5). Preliminary results from 2005/6 are mixed: Tesco continued its strong profit growth with higher sales, but Morrison made a loss.

<sup>4</sup> Henceforth, “grocery sales” is a shorthand for all sales through grocery outlets, including non-grocery items

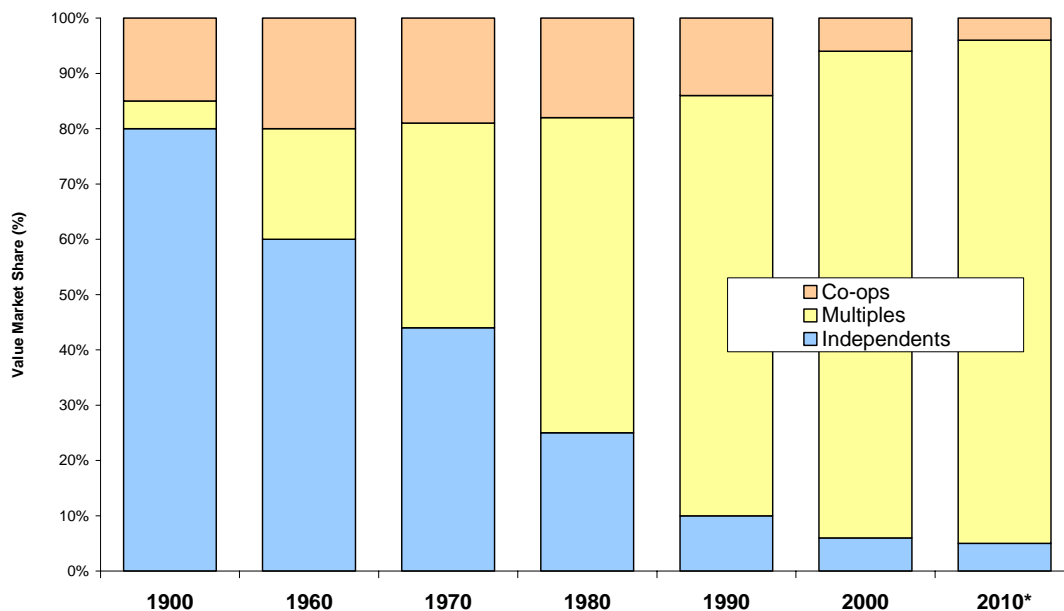
<sup>5</sup> “Traditional Retailing and Developing Convenience” comprises small stores, typically under 3000 sq ft, which stock a range of specialist products. This includes newsagents (selling confectionary, tobacco and newspapers), specialist grocers, specialist off-licences, food specialists (chains of bakers, butchers, health foods, etc.) and independent specialists.

<sup>6</sup> GVA measures the difference between a sector’s sales and the value of its purchased inputs. The estimates provided are in basic prices.

## KEY TRENDS IN UK GROCERY RETAILING

12. The concept of **multiple retailing** – one firm operating ten or more stores – is not new. From the late 19<sup>th</sup> century, urbanisation, rising incomes, combined with mass manufacturing technology, facilitated national branding of grocery products and the pursuit of **economies of scale**. The concept of **one-stop grocery shopping** ‘under one roof’ can also be traced back to the large urban food market halls of the 19<sup>th</sup> century. These trends increased in the first half of the 20<sup>th</sup> century, as successful grocery chains like Tesco and Sainsbury expanded. The advent of **self-service** in the 1950s heralded the inexorable rise of multiple supermarkets, at the expense of independent stores<sup>7</sup> and co-operatives (see Figure 2). Pedestrianised, day-to-day shopping at small specialist shops and independent grocers has thus given way to bulk weekly shopping by car.
13. This retail revolution has been underpinned by **socio-economic trends** on the demand side:
- busy consumer lifestyles, with rising incomes;
  - an increase in household numbers and women working;
  - wider car ownership and the falling cost of car travel;
  - wider ownership of fridge freezers.

**Figure 2 The Consolidation of the UK Grocery Market, by Value Market Share**

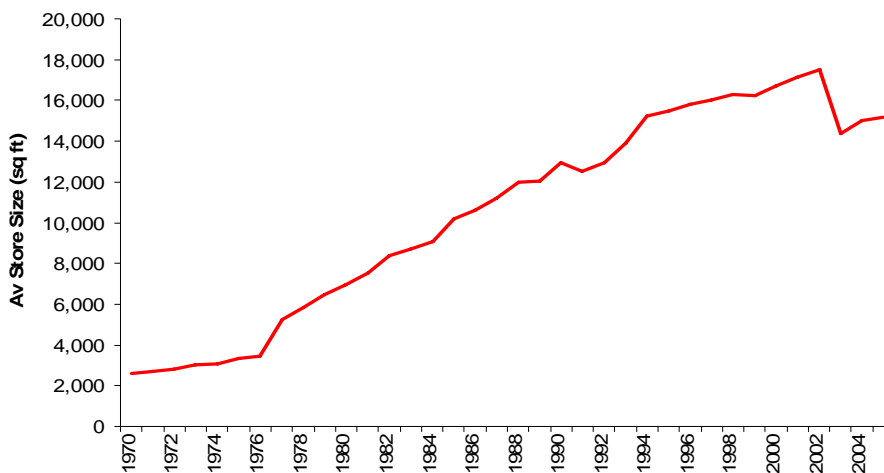


source: IGD Grocery Retailing 2004. \*2010 is IGD estimate. The 'multiples' category appears to include symbol-group convenience stores and so is not directly comparable with Figure 1.

<sup>7</sup> A retailer that owns a single store, or a chain with fewer than 10 stores.

14. New **technology** has allowed retailers to reap further scale economies in logistics, distribution, warehousing and purchasing. Modern multiple retailers have come to organize wholesale and logistic systems themselves and influence supply chains. Wholesale markets have declined, in turn narrowing the supply base for independent retailers.
15. Demand and technological trends have reinforced each other. Larger stores with wider product ranges have encouraged consumers to make larger, less frequent shops. Technological improvements (i.e. stock control; checkout scanning; fresh produce; longer shelf-lives) have further reduced costs and attracted consumers. Loyalty card schemes have given retailers new insight into **consumer preferences** and enabled them to get more involved in product development.
16. The **value of sales** through grocery outlets has increased by 3% per annum in real terms over the last 10 years. This growth reflects rising non-grocery sales and higher average spend (i.e. better quality or 'premium' food; more convenience purchasing).
17. Growing investment by the major multiples in the convenience sector has slowed the upward trend in **average store size** (Figure 3). During the 1980s and 1990s, smaller high-street outlets were replaced with larger (often out-of town) supermarkets. In recent years, however, the demand for **convenience retailing** has increased, reflecting growing incomes and the increasing value placed on leisure time. This has provided new market opportunities both for symbol groups (such as Spar and Costcutter) and existing supermarket retailers. The noticeable dip in average store size for the major multiples in 2002 (shown in Figure 3) reflects this. For instance, it includes Tesco's acquisition of T&S, which added over 1,200 small stores to its store portfolio.

**Figure 3 Average Size of Major Multiples' Grocery Stores (1970-2005).**



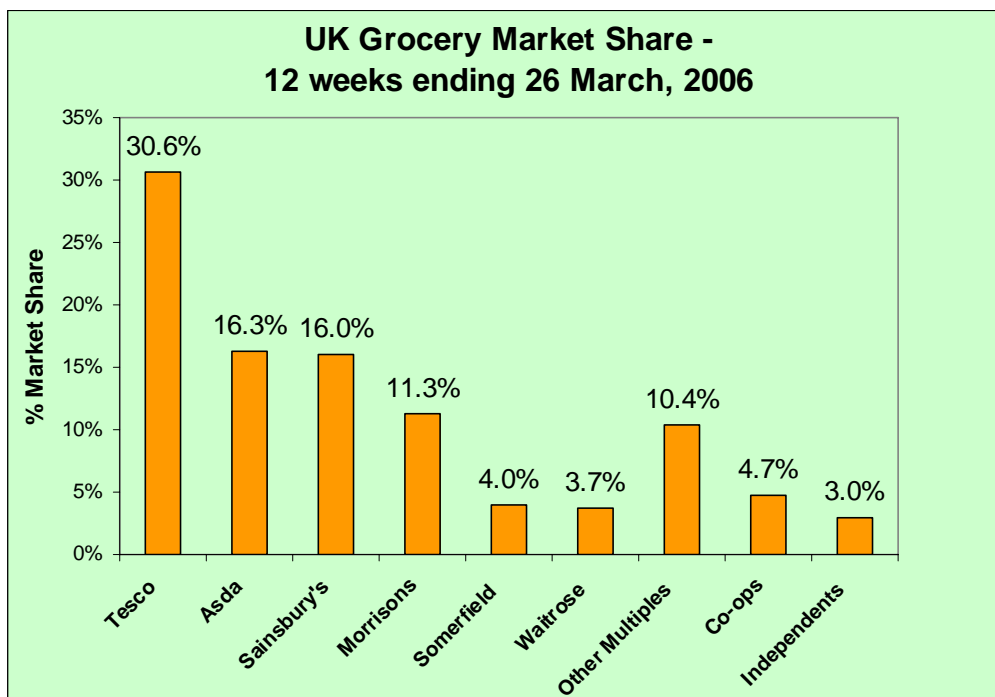
source: IGD Grocery Retailing 2005

## MARKET STRUCTURE

### Aggregate market shares

18. **Tesco** currently has a commanding, and steadily increasing, 30 % share of the non-convenience UK grocery market (Figure 4). During the 1990s, Tesco and Sainsbury enjoyed similar market shares (of 20 to 25 %), but Sainsbury has since lost ground.
19. Most of the multiples' growth has been organic, with the exception of Morrison's acquisition of Safeway in 2003. Asda was acquired in 1999 by Wal-Mart, the world's largest retailer. The other market leaders are all UK companies.

Figure 4 Market shares within the non-convenience grocery market



source: TNS Worldpanel, March 2006.

20. The combined market share (excluding convenience retailing) of the largest four retailers in Figure 4 increased to 74.2 % in 2006, up from 74.1 % a year before.
21. The average shares in Figure 4 mask **regional variations**. These are highlighted by recent analysis of market shares in 120 postal districts across Britain.<sup>8</sup> Table 2 shows that Tesco has the largest market share in 56 % of postal districts. In many other districts, it generally has the second largest market share. Tesco's largest market shares are in Milton Keynes (50%) and Inverness (51%). However in other areas where it leads, its share is only a few percent more than its nearest rival. This suggests that

<sup>8</sup> By market analysts CACI, summarised in *The Grocer*, 22 October 2005.

Tesco is never completely without competition and does not dominate evenly.

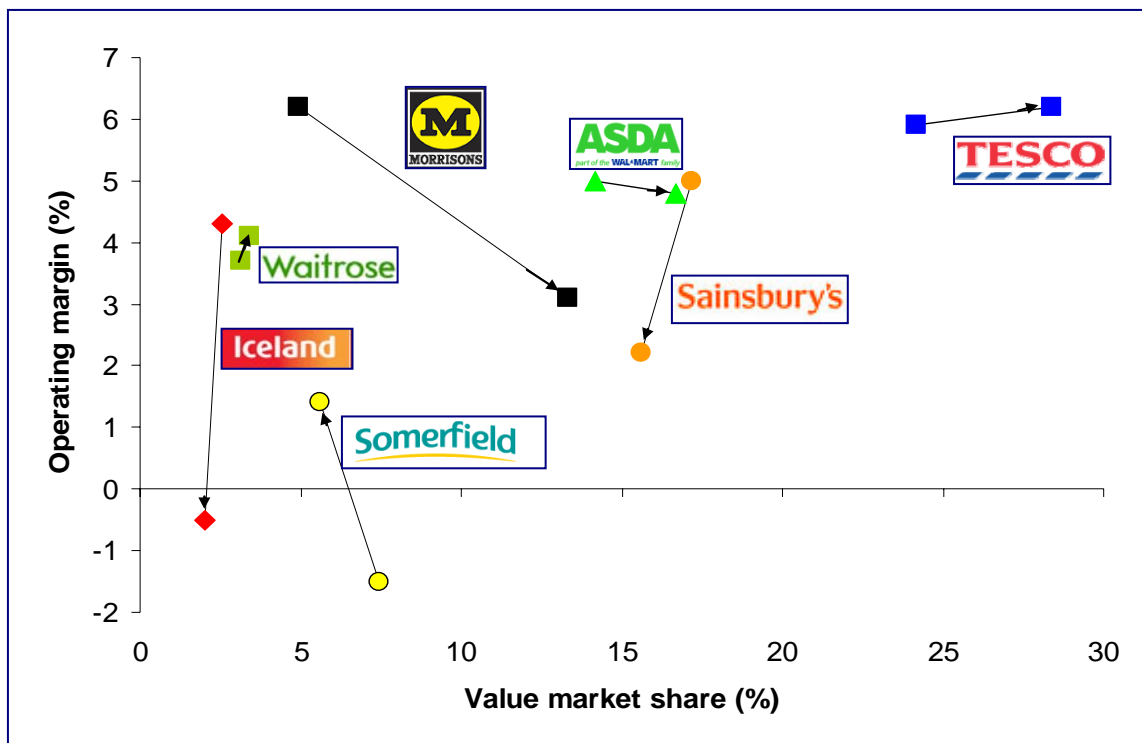
**Table 2 Market leadership by GB postal district, 2005**

	Number of districts in which retailer has largest market share	% of total districts
Tesco	67	56%
Asda	23	19%
Sainsbury	14	12%
Morrison	13	11%
Somerfield	3	2%
<b>Total postal districts</b>	<b>120</b>	

Source: CACI, The Grocer.

22. Figure 5 shows the direction of major retailer **profit margins and market shares**<sup>9</sup> between 2000/1 and 2004/5. It contrasts Tesco's strong performance (margins and market share rising) with Sainsbury's 'spiral of decline' (margins and market share falling). Morrisons has grown by acquiring Safeway, but conversion costs have eaten away at margins.

**Figure 5 Movements in operating margins and market shares of the major grocery retailers, 2000/1 - 2004/5**



source: IGD Grocery Retailing 2005. Shares broadly correspond to Figure 4 and include non-grocery items.

<sup>9</sup> Market shares exclude convenience stores, although operating margins may be derived from all formats in which the stores operate.

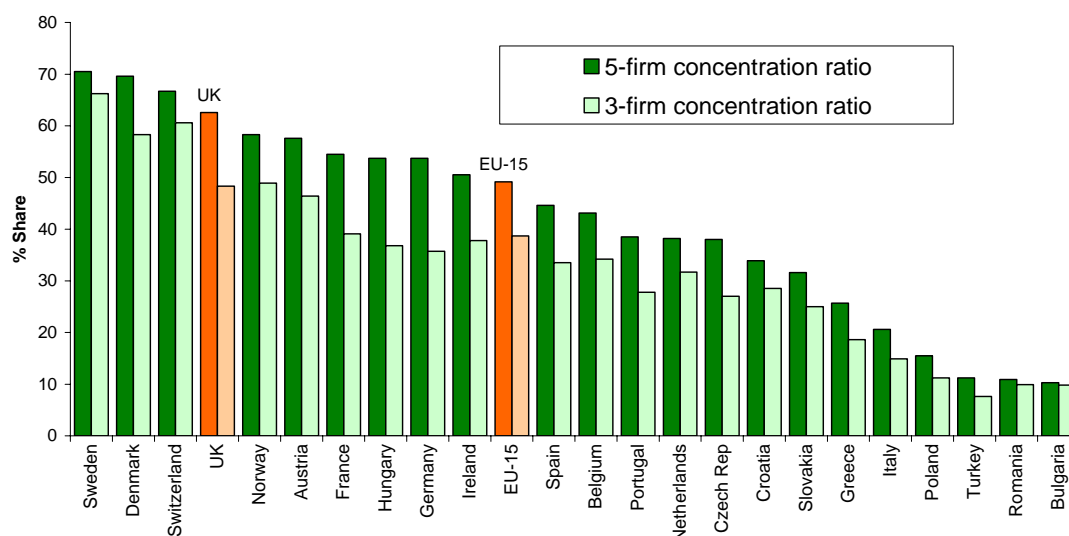
23. **Convenience retailing** is consolidating. The large multiples have begun to compete strongly in this sector (e.g. *Tesco Express*, *Sainsbury's Local*) and have acquired some existing chains and forecourts. Meanwhile, the **symbol groups** are increasing market share by opening new stores and providing better service within those stores. Consolidation in convenience has been driven by

- the need to develop economies of scale;
- the need to acquire the best quality sites;
- opportunities to reduce costs and increase sales by applying best practice to these new sites.

24. Well-sited, attractive and well-stocked convenience stores are ideally placed to meet consumer needs for top-up and 'on-the-move' shopping. IGD forecast convenience's share of the total grocery retail market (as given in Figure 1) to increase from 20% to nearly 24% **by 2010**.

25. The UK has one of the more concentrated grocery retail sectors in **Europe**, as measured by the market share of the 3 or 5 largest firms. Figure 6 shows that the top five UK grocery retailers accounted for 63 % of the total grocery market in 2004. **NB** - *The European shares are broadly consistent with the data in Figure 1. In both Figure 1 and Figure 6 the grocery market is widely defined to include the convenience sector, so the shares are not directly comparable to the TNS data in Figure 4 which excludes convenience retailing.*

**Figure 6** Share of largest retailers in European grocery markets, 2004



source: IGD European Grocery Retailing 2005. Shares based on all grocery retailing formats.

26. The UK's relatively concentrated grocery market in comparison to mainland Europe, reflects historical, institutional and cultural factors:

- the generally more liberal environment in the UK in terms of planning and competition policy, particularly in the 1980s;
- following the War, mainland Europe maintained a strong culture of specialist food suppliers, reflecting strong consumer food awareness;
- at the same time, continental hypermarkets grew up on low prices, whilst UK supermarkets have developed a quality / price package;
- a stock-market driven corporate culture in the UK has encouraged new retail strategies and ongoing innovation;

These differences, however, appear to be lessening over time. Indeed, Figure 6 understates the concentration facing suppliers in many continental countries, where large **buyer groups** have arisen. Adjusting concentration ratios for this additional retail buying power increases the EU15 average by several percentage points, close to the UK figure (Dobson et al, 2003).<sup>10</sup>

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<sup>10</sup> These concentration ratios are similar, but not identical, to the various concentration measures quoted in the 2004 London Economics study on retail and farmgate price spreads. What is clear is that concentration in the UK grocery market is not out of line with experience elsewhere in western Europe.

## HOW RETAILERS COMPETE

27. Two key factors drive the nature of competition between supermarkets:

(i) Because they are closest to consumers, and have sophisticated sales information, distribution and stock control systems, large retailers are well placed to **manage the supply chain**, in both own-label and private-label goods. In effect, they are the 'gatekeepers' of a sophisticated consumer base, rewarding firms who can best meet consumer demands.

(ii) Grocery retailers are competing within a relatively **mature market**:

- a stable population limits growth of food consumption, although trends vary between food types as demographics and consumer preferences change (e.g. more single-person households; increasing awareness of health issues).
- food expenditure (other than eating out) accounts for a declining share of household budgets.
- tight planning restrictions limit new store building.

28. This has driven multiple retailers to:

- fiercely compete for market share through **price, range and service**;
- **diversify** into non-grocery products and services;
- shift to **premium** products;
- enlarge existing stores and open high-street **convenience stores**.

29. Further concentration in the sector is limited by competition policy. Indeed, the fact that market shares have moved around over time (Figure 5) is witness to strong ongoing competition in grocery retailing.

### Price competition

30. Price competition between supermarkets is evident:

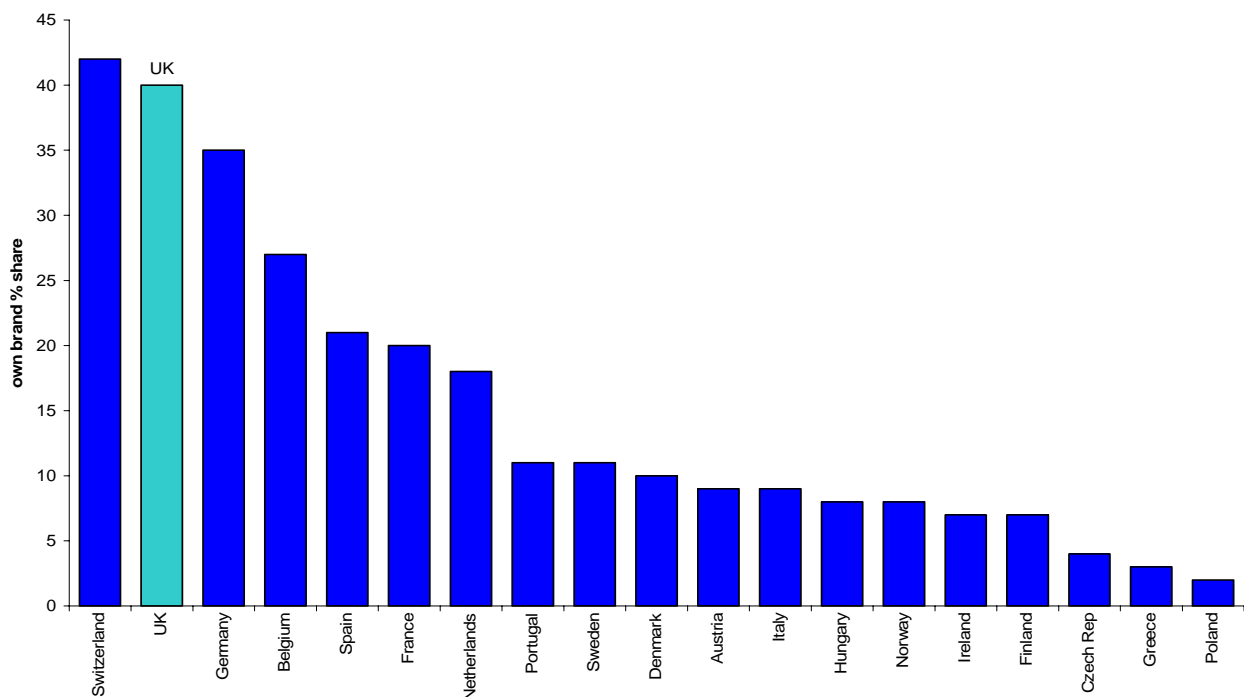
- Operating margins are generally low (averaging 4.2% in 2004/5)
- Despite their low market share, competition from 'discounters' (e.g. Lidl, Aldi, Netto) has led multiples to develop new strategies, such as 'economy' own brands and local pricing targeted at particular retailers.
- Wal-Mart's acquisition of ASDA in 1999 led to more "Every Day Low Pricing" in ASDA stores, with price cuts in "Known Value Items" (e.g. milk, bread, bananas). Tesco and Morrison quickly followed suit.
- Wide range of promotional price activity on (usually) branded groceries.
- Morrison's acquisition of Safeway led to harmonizing price cuts of some 12-14% across ex-Safeway stores in 2004.
- Since 2004, Sainsbury's have deliberately cut 6000 prices in order to regain customer loyalty and market share.

31. IGD research suggests that 'low prices' are still a key motive for visiting a particular supermarket by the majority (58%) of consumers. 68% of 'loyal' shoppers stay with their chosen supermarket for that same reason. This is reinforced by the prevalence of price-led advertising in the media. However, it is not clear whether shoppers really know how prices between stores differ beyond "Known Value Items".
32. Fierce price competition has in turn put **pressure on suppliers** to be proactive in supporting the cost efficiencies required to maintain low prices. This is likely to continue.

### Quality competition and "Own Brands"

33. As noted earlier, UK supermarket growth has never been based purely on price, but on '**value for money**'. Consumers weigh up quality of product and service against the money and sacrifice involved in buying groceries. Hence, the minor share of so-called 'deep discounters' in the UK.
34. Some retailers have tailored their offer to compete more on product quality than price (e.g. Waitrose, M&S), whilst others focus on low prices (e.g. Asda). Sainsbury has recently begun to focus on price as well as quality.
35. **Retailer brand** ("own brand" or "own label") ranges have expanded across all food types, allowing retailers to present multiple quality-price offers (e.g. good, better, best, healthiest, kids, organic) and attract a wide customer base. The UK has long been a European leader in own-brand products (Figure 7). Indeed, M&S is 100% own-brand.

**Figure 7 Own brand share of grocery market by country, 2004**



source: IGD European Grocery Retailing 2005.

36. Own brands generally give better margins. They also help to promote the overall image of the retailer with minimal advertising effort.
37. **Premium product lines** (eg *Finest, Taste the Difference*), particularly prepared meals, are growing fast, and reflect not just 'cash rich – time poor' consumers, but also competition with the eating out sector.
38. Own brand ranges have given retailers greater incentives to get more involved in product development, although this may have been at the expense of innovation by branded manufacturers.

### Other dimensions of competition

39. **Larger store formats** have become common, either through new 'out-of-town' stores, or expansion of existing stores. This has enabled retailers to boost their non-grocery lines. In 2005, the number of larger format stores (>40,000 sq. ft.) increased by 12%.
40. These larger stores have facilitated rapid expansion into **non-food areas**. Whilst non-food lines have enjoyed annual sales growth of 6-25%, food sales have grown at around just 3.5%. Non-grocery items increase consumer interest and boost footfall. They now account for up to 10% of supermarket sales. Leading lines are electrical goods, housewares, flowers, newspapers and magazines, books, videos and DVDs.
41. Supermarkets also compete hard on **fuel sales**. By accepting lower margins on petrol than groceries, supermarkets use competitive fuel prices to encourage footfall and increase sales. (CC, 2000).
42. At the same time, large multiple retailers have sought growth by moving into the fast-growing **convenience sector**. Such expansion involves fewer planning hurdles. Because of their small market share in this area, large retailers tend to compete with smaller independent and symbol stores. Convenience stores also help to promote the retailer brand.
43. **Long opening hours** (including 24-hour and Sunday opening) in supermarkets is now common practice, blurring the distinction between convenience and bulk shopping, although the restrictions in the Sunday Trading Act remain in force.
44. **Customer service** is another key aspect of supermarket competition. Product availability, shop ambience, aisle space, easy navigation, queuing times and helpfulness of staff all figure in *The Grocer* magazine's weekly "mystery shopper" assessment of stores.
45. **Loyalty card schemes** provide discounts to consumers, and enable better targeting of product ranges to individual preferences as revealed by loyalty card purchase data. It is thought that Tesco has been particularly successful in this area in recent years. Such schemes help to extend the multiples' competitive advantage over smaller retailers.
46. 1.5 million households now make use of **internet shopping** for groceries. Here again is an area in which independents are less able to compete.

## SUPERMARKETS AND SUSTAINABILITY

### Economic performance

47. The **2000 Competition Commission (CC) report** on supermarkets (hereafter CC, 2000) concluded that “the industry is currently broadly competitive and that, overall, excessive prices are not being charged, nor excessive profits earned.”
48. Supermarket **profit margins** range typically between 2% and 6%, and have edged down since the CC study (see Figure 5). According to *The Grocer 150 Index* for 2005, the average profit margin of UK food and drink manufacturers was 8%, with the three largest companies (Cadbury Schweppes, ABF and Tate & Lyle) averaging 12%.
49. Another measure of profitability – **Return On Capital Employed (ROCE)**<sup>11</sup> — tends also to be greater among food and drink manufacturers (20-25%). Only Tesco shows comparable returns (20-22%).<sup>12</sup>
50. Supermarket margins also lag behind other major UK retailers, despite higher absolute levels of sales and profits (Figure 8).

**Figure 8 Sales and profit margins of selected well known UK retailers**

Company Name	Sales (£m)	Operating Profit (£m)	Operating Margin (%)
BHS, UK	890	138	15.5
Next, UK	2,516	371	14.7
Boots, UK	5,325	550	10.3
Marks & Spencer, UK	8,302	824	9.9
Debenhams, UK	1,810	157	8.7
HMV, UK	1,793	132	7.3
<b>Wm Morrison Supermarkets, UK</b>	<b>4,944</b>	<b>305</b>	<b>6.2</b>
<b>Tesco, UK</b>	<b>30,814</b>	<b>1,818</b>	<b>5.9</b>
Dixons, UK	6,492	272	4.2
<b>Sainsbury, UK</b>	<b>17,141</b>	<b>656</b>	<b>3.8</b>
<b>Broadstreet (Wal-Mart), UK</b>	<b>13,326</b>	<b>475</b>	<b>3.6</b>
Carphone Warehouse, UK	1,849	56	3.0
Woolworths, UK	2,775	79	2.8
John Lewis, UK	4,500	110	2.4
<b>Somerfield, UK</b>	<b>4,521</b>	<b>41</b>	<b>0.9</b>
<b>Safeway (now part of Wm Morrison),</b>	<b>8,386</b>	<b>54</b>	<b>0.6</b>

source: DTI Added Value Scoreboard 2005

51. Low margins reflect strong price competition but can also indicate rising costs and sluggish productivity growth. In particular, Tesco’s profitability

<sup>11</sup> Return on Capital Employed (ROCE) expresses net operating profit as a % of a company’s capital assets, and provides a useful guide to a firm’s long-run profitability.

<sup>12</sup> *The Grocer / OC&C Top 150 Index*, July 2 2005. ROCEs for leading supermarkets reproduced in Milk Development Council’s report on dairy margins (Sept 2005).

and improved performance by Sainsbury in 2005/6 contrasts with poorer performance by Asda and recent losses by Morrison.

52. Despite the huge efficiency improvements brought about by the rise of supermarkets since the 1960s, latest research indicates that aggregate **total factor productivity (TFP)** – comparing growth in outputs and inputs – in food retailing fell over the four years to 2002, although it has recovered strongly since.<sup>13</sup>
53. This is not necessarily cause for concern. Longer store opening hours, a greater focus on service and the rapid expansion into convenience may actually *slow productivity* growth; but such changes have helped to create the high-quality retail environment that has impressed foreign retailers.<sup>14</sup> Equally, a supermarket might improve its productivity in the short-term by reducing workforces or product ranges, but the longer queues and poorer choice that would result could drive customers elsewhere. This emphasis on the **shopping experience** appears to reflect UK consumer preferences, and may help to explain why the ‘deep discounter’ retail format is less prominent here than elsewhere.
54. Of course, efficiency is key to a retailer’s profitability and competitive edge. Supermarkets generally look at a basket of measures to obtain a wider overview of their performance than focussing on TFP alone. **Space productivity** – sales from a given unit of space – is considered to be particularly important, and partly reflects store size (Table 3). It is often published in annual reports alongside more traditional measures, such as employee productivity, financial productivity (operating profit margin, ROCE) and asset productivity (OXIRM, 2004).

**Table 3 Space Productivity of major supermarkets (£ sales per sq ft per week).**

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
<b>Tesco</b>	18.0	18.3	21.0	21.3	21.7	22.4	21.9	22.5	23.9
<b>Sainsbury</b>	20.0	20.6	20.7	20.3	16.8	17.5	17.1	16.7	16.4
<b>Asda</b>	15.2	16.3	16.9	18.3	19.1	20.0	20.5	21.0	22.3
<b>Morrison</b>	14.3	14.7	14.9	15.7	16.5	17.7	18.6	19.8	16.8
<b>Somerfield</b>	9.7	9.3	9.1	8.6	8.0	8.2	8.5	9.5	9.5
<b>Iceland</b>	7.2	7.9	8.7	9.4	10.3	8.3	7.8	8.0	7.8

source: IGD grocery retailing 2005.

55. Two factors, however, may have hampered retail efficiency in the UK over recent years:

<sup>13</sup> Research for Defra by Scottish Agricultural College and additional work by Defra. A 1998 international study by McKinsey found that “in terms of total factor productivity - labour and capital productivity combined – the United Kingdom (in 1995) sets the global standard jointly with France.” McKinsey Global Institute, *Driving Productivity in the UK Economy* (October 1998). [http://www.mckinsey.com/mgi/reports/pdfs/ukprod/Food\\_retail.pdf](http://www.mckinsey.com/mgi/reports/pdfs/ukprod/Food_retail.pdf)

<sup>14</sup> See a recent study for the DTI by the Oxford Institute of Retail Management, *Assessing the productivity of the UK retail sector* (April 2004), esp. ch. 2. The reference to foreign retailers is in para 5.2.

- **Planning restrictions** may directly or indirectly impede competition (OFT, 2006). They may also limit the scope for profitable restructuring and efficient expansion by existing operators. Given the relationship between productivity and store size, this is potentially significant.
- Performance in the **use of ICT** (Information and Communications Technology) has been mixed. Whilst Tesco and Asda appear to have followed good American practice in ICT investment, Sainsbury and Morrison have both encountered severe problems with the implementation of new ICT systems in recent years (IFS, 2004).

### Is Tesco's 30% market share a cause for concern?

A recent Harris survey of over 2000 adults was carried out for *The Grocer* (15<sup>th</sup> October 2005). It reports that, although 32% agree that Tesco has become 'too powerful', 56% accept that shopping at Tesco is 'better than shopping at any other supermarket' and 48% agree that it "sells good quality food at low prices". Tesco's success appears to have been based both on increasing operational efficiencies and meeting customer demands.

Tesco's move in to the convenience sector – it has a 6% market share - has led incumbent operators to complain about unfair competition (see para 64).

Despite Tesco's current ascendancy, competition remains strong, and if Tesco is seen to abuse its position or become complacent its market share and / or profitability could quickly erode. This happened to Sainsbury's in the 1980s and Marks & Spencer in the 1990s. Reputation and consumer trust are critical to commercial success in grocery retailing.

### Impact on consumers

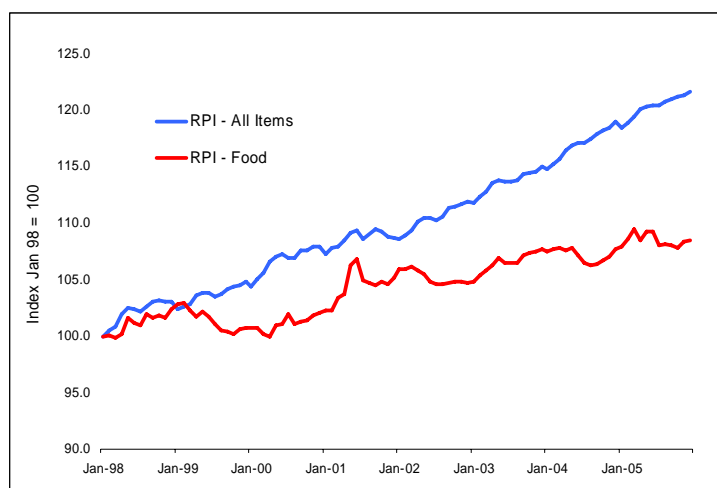
56. When referring the grocery market to the Competition Commission (CC), the **OFT** noted that "consumers have benefited in recent years from falling prices, an increase in product range within stores, and an apparent improvement in service" (OFT, 2006). However, it identified several features of the market that have the potential to harm consumers, including :

- aspects of the planning system and landholding which may restrict competition between supermarkets in a locality;
- supermarket buying power which may limit consumer choice by undermining the viability of alternative business models (such as wholesaler-supplied convenience stores).

57. Evidence obtained by the CC in 2000 showed very high levels of **customer satisfaction** regarding the quality, range and service provided by their regular supermarket. More recently, a report by Verdict Research found that supermarket entry into the convenience sector had "brought fresher food, new ranges, lower prices, better store environments... [and] forced smaller players to improve" (OFT, 2006).

58. Supermarkets also appear to have made food more affordable for consumers. ONS statistics reveal that **real food prices** declined 7.3 per cent between January 2000 and December 2005 (Figure 9), a period when the power of supermarkets increased dramatically. Indeed, the OFT looked at a group of commonly purchased products and found that prices were about 10 per cent lower in the four largest supermarkets compared to the aggregate ONS statistics (OFT, 2006).

**Figure 9 Changes in RPI (all items) and RPI (food) over time.**



Source: Retail Price Index (ONS)

59. Consumers have not only benefited from competitive food and grocery prices. The large supermarkets are becoming increasingly competitive in **non-grocery markets** such as petrol (where supermarket sales account for some 30% of the total), financial services, household goods, children's clothing, best-selling books and music. Larger stores are now selling hi-tech equipment and kitchen appliances.

### Social inclusion

60. The CC found no evidence of supermarkets systematically avoiding low-income areas to become 'food deserts'.
61. Low-income consumers have benefited from 'economy' own-label ranges. These ranges were a response to the low prices of 'discount stores' such as Kwik Save, Aldi and Lidl.
62. Those without cars may have relatively less choice where supermarkets have been sited out of town. As affluence grows and car ownership increases, people tend to use their cars for a weekly shop.
63. Tesco has been particularly successful in attracting shoppers from all social categories, including minority ethnic groups.

## Impact on independent food retailers

64. The entry of supermarkets, notably Tesco and Sainsbury's, into **convenience** has increased competition and raised standards in that sector. This has put further pressure on independent stores and their suppliers, and appears to have quickened consolidation amongst symbol groups. The Association of Convenience Stores (ACS) has expressed two specific fears in this regard. First, supermarkets may "obtain better terms from suppliers to such an extent that suppliers are forced to charge higher prices to their other customers". Second, supermarket "buyer power could undermine the viability of the wholesale distribution network serving independent stores". Further investigation will be made by the CC, but the OFT note that part of the price differences will reflect "differences in the costs of supplying different customers" and the economies of scale intrinsic to large supermarket operations (OFT, 2006).
65. The OFT also notes issues around below-cost selling in convenience stores owned by large retailers, and the potential this could have to distort competition in the convenience sector (OFT, 2006). Despite complaints about 'price flexing' - where supermarkets charge lower prices at locations with the most competitors and higher prices elsewhere - the OFT has "no conclusive evidence that any competitors have been driven out of the market as a result" (OFT, 2006).<sup>15</sup>

## Impact on suppliers and other businesses

66. Thirty years ago, **food manufacturers** controlled retailers through strong brands and enjoyed high margins. Because of their dominant market share and buying power, multiple retailers are now the leading influence on the supply chain. Negotiating power favours supermarkets as it is easier for them to change suppliers than for suppliers to find new customers. For instance, in 2000, the top five supermarkets accounted for an average of 65.5 % of UK sales for a group of large suppliers; among Tesco's 2,600 suppliers, the largest accounted for only 2.6 % of its purchases (CC, 2000).
67. **Own brand** products reflect increased collaboration between retailers and supplying firms, and have enabled second-ranking food manufacturers to compete against the brand leaders. Manufacturers of branded products now have to compete not only for listings, but also for decent shelf-space with own brands. Manufacturers have responded to these new competitive pressures by increasing productivity, consolidating and making efficiency gains. This has kept margins, at least for the larger suppliers, broadly healthy.<sup>16</sup> Genuine **product innovation** may, however, have suffered as retailers' rapid imitation of branded products reduces the rewards to innovation.

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<sup>15</sup> In its 1999-2000 investigation, the CC highlighted concerns about unbalanced price competition across product lines and regional price variation ('price flexing') in 2000, but concluded that potential remedies were neither effective nor efficient.

<sup>16</sup> See Defra, *UK Food and Drink Manufacturing: an economic analysis* (May 2006).

68. As grocery retailers expand into non-grocery markets, the pressure for **consolidation** and efficiency improvements among high street retailers is also likely to increase.
69. Whilst the decline of specialist independent shops has impacted on localised suppliers, the growth of supermarket chains has also opened up a national market to **regional** and **smaller suppliers**. Centralised supermarket distribution systems limit the scope for stocking **local produce**, but growing consumer interest in local produce is creating strong incentives for supermarkets to source locally. For instance Asda has created a dedicated local sourcing unit that works with 200 local suppliers, and other major supermarkets are adopting similar measures.<sup>17</sup>
70. Meeting supermarket requirements for assurance and traceability is critical to the sustainability of **farm-based suppliers**, even if it increases their 'regulatory burden'.<sup>18</sup> However, few farmers supply supermarkets directly, as supermarkets tend to deal with larger processors and pre-packers.
71. Suspicion that UK **farm-gate prices** have been squeezed by supermarkets has been widespread ever since UK farm incomes collapsed in the late 1990s. Research for Defra by London Economics (2004) provides no evidence to support such claims. Farm-gate prices are driven by a range of factors (e.g. exchange rates, world commodity markets, degree of added value in farm produce); so too the spread between retail and farmgate prices (e.g. degree of processing and packaging, retail efficiency, energy and regulatory costs, etc).
72. There are concerns that the large supermarkets, driven by fierce competition, take a short term, cost-minimizing view which threatens the long-term health of the domestic **supply chain**. However, there is little evidence for this. Retailers look for competitive, consistent, good quality produce in response to consumer demands, whether that is from domestic or overseas suppliers. Domestic suppliers enjoy the competitive advantage of being located close to retailers and consumers. The power of supermarkets has encouraged farmers and other suppliers to become more, not less, competitive and 'market orientated'.<sup>19</sup>

### Employment impacts

73. Although new stores have created jobs, other jobs have gone as specialist shops have closed, and the net employment impacts have been hotly debated (CC, 2000). To the extent that superstores are more efficient, employment in grocery retailing would be expected to decline. However, rising sales (including non-grocery items), longer opening hours and increased customer service have tended to increase employee numbers.
74. Total *employees* in food and drink retailing increased by about 45% between December 1993 and December 2005 (ONS data). It is clear that

<sup>17</sup> <http://news.bbc.co.uk/1/hi/business/4316207.stm>

<sup>18</sup> Evidence from ADAS focus groups for the Farming Regulation and Charging Strategy.

<sup>19</sup> See, Defra, *UK Food and Drink Manufacturing: an economic analysis* (May 2006).

supermarket expansion has created many new part-time jobs, which, have particularly suited women (re-)entering the workforce (CC, 2000).

### Social and ethical issues

75. As both retailer power and consumer awareness has increased, retailers are becoming more answerable for supply chain issues (e.g. gangmaster labour, the health of domestic agriculture, animal welfare standards, overseas labour standards, etc). This creates both threats and opportunities for supermarkets.
76. Supermarkets increasingly support organic food and the Fairtrade mark. Mintel reports that this “*has been a significant factor stimulating the market. Ethical choices are now easier and more convenient to make and this has attracted spend from consumers not strongly committed to ethical buying.*”<sup>20</sup> In addition, most supermarkets are signed up to recognised ethical trading schemes, such as the Ethical Trading Initiative. Participation in these initiatives have in turn enabled supermarkets to benefit from the growing markets in these areas.
77. Supermarkets also react rapidly to **health concerns** (e.g. BSE, Sudan 1, GM food, etc). Their sophisticated and large communications networks facilitate **traceability** and rapid and co-ordinated responses to other threats to the supply chain. This can be a source of competitive advantage, as quick product recalls can help to build consumer trust. Furthermore, the introduction of clearer labelling showing the fat, sugar and calorie content of products has allowed supermarkets take advantage of the **increased consumer awareness of health issues**.

### Environmental issues

78. Most food now passes through supermarket distribution centres and is transported to stores in large Heavy Good Vehicles (HGVs). This has raised concerns about the environmental and traffic impacts of supermarket retailing. However, efficiencies in distribution and logistics led to a reduction in the total **distance travelled by HGVs** between 1997 and 2002. This was achieved through more efficient loading of vehicles, as the weight of food transported by HGV actually increased over the period, reducing the negative environmental impact per tonne of food transported.<sup>21</sup>
79. Supermarkets are consciously taking measures to improve **transport efficiency**. Tesco recently increased the volume of goods delivered per litre of fuel consumed by 2.5 % by “using lorries returning from [stores] ... to collect goods from suppliers and recycling waste”, enabling it to reduce

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<sup>20</sup> Mintel, *Attitudes towards ethical foods - UK* (February 2004).

<sup>21</sup> AEA Technology, *The Validity of Food Miles as an Indicator of Sustainable Development, Final Report produced for DEFRA* (June 2005).  
<http://statistics.defra.gov.uk/esg/reports/foodmiles/>

the miles travelled between suppliers and distribution centres by 23 % and fuel usage by 14 %.<sup>22</sup>

80. Although increased local sourcing would probably reduce the average distance travelled by food it would probably involve the use of smaller vehicles and less efficient loading. The environmental impact of food transport depends on the mode and utilisation of transport that is used as much as physical distances covered.<sup>23</sup>
81. National distribution networks facilitate food **imports** by supermarkets, but imports per se are no less environmentally sustainable than home production.<sup>24</sup>
82. Changing shopping patterns are more of an issue. Increased **car usage** by shoppers has had a negative environmental impact. Indeed, the car miles associated with grocery shopping increased by over a third between 1992 and 2002, reflecting growing affluence, car ownership and the increase in bulk grocery shopping. Multiples' entry into the convenience sector may help to stem this trend, but the environmental impact of car usage is a wider social problem and has more causes than just food shopping alone.
83. More generally, supermarkets are seeking to improve **energy efficiency** in order to make cost savings and enhance their image. Tesco, for example, was able to reduce energy consumption per square foot of sales space by nearly 35 % between 1997 and 2005.<sup>25</sup> In May 2006, Tesco announced a new £100m capital fund to invest in innovative environmental technology, including wind turbines, solar energy and gasification techniques.

### Local sustainability

84. Whereas France, Italy and Germany imposed tight **planning restrictions** at an early stage, relatively liberal guidance in the UK up to the 1990s facilitated rapid growth in out-of-town supermarkets. These have had adverse impacts on smaller town centres, particularly those where existing provision is weak. Revised, stricter, planning guidance (PPG6) in the mid-1990s has shifted in favour of town centre building. Yet the OFT recognises that the planning regime has the potential to restrict the development of large stores and competition between chains at local level.
85. The development of out-of-town supermarkets may have contributed to the decline of certain **town centres**, with consumers less likely to visit other stores. This may have undermined **community cohesion**, which could be considered a local 'public good' that is underprovided by the free market.

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<sup>22</sup> Tesco, *Vehicle Efficiency* (April 2005). <http://www.tescocorporate.com/vehicleefficiency.htm>

<sup>23</sup> Sea transport is relatively benign, accounting for 65 % of food tonne kilometres but only 12 % of CO<sub>2</sub> emissions, whilst air freight is more polluting, accounting for less than 1 % of tonne kilometres but over 10 % of CO<sub>2</sub> emissions

<sup>24</sup> As the AEAT study shows, it is possible, for example, that imported fruit produced in countries with hotter climates may be more sustainable than domestic fruit grown in heated greenhouses

<sup>25</sup> Tesco, *Resources* (June 2005). <http://www.tescocorporate.com/resources.htm>

However, supermarkets themselves are increasingly seeking to promote their community role through educational involvement, fundraising and sponsorship, sports schemes, etc.

86. By contrast, supermarkets' entry into the growing **convenience market** may have a positive impact on town centre life. Yet some remain concerned about the decline in the visual diversity of town centres, with the local character of independent shops being lost and replaced with the common fascias of national chains, grocery or otherwise.
87. Whilst the regional distribution system of supermarkets limits the degree for stocking local produce, the demand for such produce offers commercial opportunities for large and small retailers. The rapid growth of urban **farmers' markets** (450 in 2002), reflects this demand and has helped to renew local identities.

## CONCLUSIONS AND OUTLOOK

88. The IGD forecast that the UK grocery market will be worth £137 bn in 2010, up from £120 bn in 2005. Most of the growth will occur in the convenience sector, which is forecast to increase from £24 bn to £32 over the period. However, after stripping out the effects of inflation, the IGD does not expect the overall grocery market to exhibit any significant growth.
89. Supermarkets are a fact of modern economic life. Collectively, they have an immense and sophisticated influence over the grocery supply chain. The UK is not unique in this.
90. Though concentrated, UK grocery retailing is very competitive, bringing many benefits to consumers. This has in turn increased competitive pressures on supply chains, which has posed both opportunities and threats to individual suppliers.
91. By competing to gain market share against independents and each other, the multiples have responded in innovative, dynamic and generally profitable ways to socio-economic change and rising consumer expectations, within the evolving regulatory and cultural framework in which they operate.
92. Supermarkets that do not anticipate and meet customer needs efficiently are unlikely to prosper.
93. Supermarket success has historically been predicated on high levels of public and political support, but that is no longer guaranteed. Concerns and adverse publicity, well-founded or not, reflect growing expectations regarding the social responsibility of supermarkets.
94. As leading grocery experts observe, supermarkets in general and Tesco in particular “will have to demonstrate – continuously – that they truly have consumer interests at heart, and that they are not abusing their enormous power just to enrich themselves” (Seth & Randall, 1999).

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## GLOSSARY

<b>Buyer group</b>	A group representing <b>independent</b> retailers which allows them to have greater market power in their relationships with suppliers and wholesalers.
<b>Concentration ratio</b>	A measure of consolidation in an industry – the proportion of sales accounted for by the largest X firms.
<b>Convenience sector</b>	Sector made up of <b>convenience stores</b> . Distinct from <b>one-stop shopping</b> in that this sector is used for ‘top-up’ shopping rather than the weekly grocery shop. Also distinct from <b>Traditional Retail and Developing Convenience</b> due to the nature of its products.
<b>Convenience store</b>	Store with sales area up to 3000 sq. ft. (allowing them to operate for more than 6 hours on a Sunday), selling core convenience groceries.
<b>Co-operative</b>	A commercial organisation owned by and run for the benefit of a body of participating members. Ownership is held in strictly equal shares per member and profits belong to these members rather than external shareholders. 38 co-operative societies are active in grocery retailing in the UK.
<b>Discounter</b>	Large (one-stop shop) retailer offering a reduced range of products at significantly lower prices than ‘standard’ retailers.
<b>Economies of scale</b>	Fall in average costs as a business grows, arising from technical, financial, purchasing, managerial and marketing economies associated with being large.
<b>Every Day Low Pricing</b>	A marketing strategy which minimizes special offers in favour of consistent across-the-board low prices.
<b>Independent</b>	A retailer owning a single store, or a chain with less than 10 stores. Independents may be members of a <b>symbol group</b> .
<b>Known Value Items</b>	Products common to all retailers (basic and branded), for which price competition is particularly important.
<b>Multiple</b>	A retailer that owns 10 or more stores/outlets.
<b>One-stop shopping</b>	The concept of buying the foreseeable bulk of one’s weekly groceries at a single store in a single trip.
<b>Supermarket / superstore</b>	Officially a store with sales area between 3,001 and 25,000 sq. ft. Also used to describe the ‘ <b>one-stop shop</b> ’ sector as a whole, or the retailers that operate within it. A “superstore” is has sales area between 25,001 and 40,000 sq. ft. but this can vary. A “hypermarket” is officially a store with sales area exceeding 40,000 sq. ft, often with non-grocery items available.
<b>Symbol group</b>	A group of <b>independent</b> retailers who display a branded fascia in order to have a common trading identity which shoppers recognise. Membership of a symbol group also gives the retailer improved buying terms, better shop technology and the chance to sell own-label products.