Micro-Marketing and Discriminatory Practices in UK Grocery Retailing

by

Professor Paul Dobson
Loughborough University Business School

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About the author:

Professor Paul Dobson

Paul Dobson is Professor of Competition Economics at Loughborough University Business School in the UK. He has held academic positions previously at the University of Nottingham (1990-98) and the University of St Andrews (1988-89). His research expertise is in the areas of competitive strategy and competition policy, with publications focusing on retail competition, brand and private label competition, supply-chain relations, pricing policies and market power. He also has extensive consulting and advisory experience. He has produced commissioned reports and acted as an adviser for numerous competition authorities, international organisations, industry associations and companies on a wide range of antitrust and competition issues, including mergers, market investigations, vertical relations, and cooperative agreements. He is an advisory board member of the American Antitrust Institute and presently affiliated to CRA International as a Senior Consultant.
(URL: http://www.lboro.ac.uk/departments/bs/staff/bspwd.html)

Contact details:

Professor Paul Dobson
Business School
Loughborough University
Loughborough LE11 3TU
United Kingdom
Tel: + 44 1509 223297
E-mail: p.w.dobson@lboro.ac.uk

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EXECUTIVE SUMMARY

Background

As a sector worth £95 billion in annual sales and dominated by a limited number of very large retail chains, grocery retailing in the UK continues to attract the watchful eye of the UK competition authorities. With concerns about the impact on competition resulting from the exercise of retail buyer power, entry barriers and strategic behaviour in relation to planning restrictions, and certain retail pricing practices, the Office of Fair Trading, in May 2006, referred the sector to the Competition Commission for a market investigation (scheduled to be completed by October 2007).

As a response to this current inquiry, and in particular the Competition Commission's Statement of Issues setting out the main aspects and concerns for its investigation, this report seeks to provide evidence and economic analysis on retailer practices used in grocery retailing markets that may potentially serve to prevent, restrict and/or distort competition and work against the interests of consumers.

Focus of report

The report focuses on the manner in which goods are marketed and sold to consumers, and whether retailer practices take advantage of imperfect competition and consumers' lack of information or mobility and different pricing sensitivity to effect outcomes that may adversely affect competition. In particular, the report centres on the manner in which powerful retail chains can segment retail markets and adapt their retail offer in ways that discriminate across consumer groups or types while potentially lessening or damaging competition. In examining whether such practices may serve to reduce or distort competition, the report considers the likely impact on consumer welfare and specifically whether such practices may individually or in certain combinations give rise to consumer detriment by allowing for higher prices, lower quality or less choice of goods and services, and/or reduced innovation.

Previous Inquiries

Previous market and merger inquiries by the Competition Commission and Office of Fair Trading in relation to this sector have highlighted concerns about the basis and emphasis on which retailers compete, and specifically whether the full range of goods and full extent of local markets served are subject to the same intensity of competition. These inquiries have singled out two practices in particular that give cause for concern that they can distort competition and work against consumers' interests. Firstly, "persistent below cost selling" on certain frequently purchased and known value items, where consumer price awareness is high, may distort consumers' purchasing behaviour and consumption patterns, but may also serve a predatory role in undermining the viability of smaller/specialist stores. Secondly, "local price flexing", whereby a retail chain sets different prices across its stores according to the intensity and nature of local competition, can mean that consumers in less competitive local markets face higher prices than they would otherwise do, and the practice can be used to distort or restrict competition by allowing for targeted predatory pricing against specific local rivals.

Discrimination and Segmentation through Micro-Marketing

This report shows that these documented practices are part of a larger set of policies that major grocery retailers can employ to discriminate and segment retail offers across consumer groups, types, and even individuals. As such, below-cost pricing and price flexing represent just "the tip of the iceberg" when it comes to the possible means that powerful grocery retail chains may have to influence and affect competition through altering and customising prices and marketing behaviour at the individual product and store level – a set of practices which fall under the term "micro-marketing".

The attraction to retailers of using micro-marketing is that it can potentially allow them to target consumers more effectively with a view to building sales levels, increasing shopper loyalty and ultimately raising retail margins and profits. At the same time, the practices can be adapted in such a manner as to offer the possibility of simultaneously employing soft and aggressive approaches towards different competitors to best suit the retailer's needs and ambitions in regard to extracting higher levels of consumer surplus while strengthening long-term market positions.

This report discusses the array of micro-marketing possibilities available to retailers which can allow them to alter and customise retail offers in a variety of ways, some subtle and others more blatant, as a means to discriminate across different consumer groups and in the process affect market outcomes. The analysis in the report suggests that such practices are endemic in UK grocery retailing and extend well beyond price flexing and persistent below-cost selling. In particular, the very detailed market information that retailers increasing possess combined with possibilities to target individuals through database marketing are adding to the scope for such practices and increasing the ability of retailers to target ever more precisely their customised offers.

Economic Effects

The report considers the economic effects of these practices and their likely impact on competitive outcomes and market dynamics, drawing on insights from recent economic theory on the operation of different forms of price discrimination in imperfectly competitive settings.

For given market configurations, economic theory demonstrates that different forms of price discrimination compared to non-discrimination can make consumers as a whole better off in some instances, and worse off in others. Much depends on the precise circumstances and form of discrimination being applied.

Specific consideration of price flexing, and associated forms of geographic discrimination giving rise to differences in value-equivalent prices across separate local markets, suggests that current market conditions may harm overall consumer welfare when it increases weighted average prices for consumers compared to more uniform local offers and/or facilitates predatory behaviour by major retailers against smaller retailers.

More generally, though, unlike perhaps other forms of discrimination that can arise in very competitive circumstances, the presence of significant price flexing is indicative of a lack of effective competition – where prices are set with respect to consumer willingness to pay and the relative strength/weakness of local competition, rather than according to cost levels. This indicates that the market as a whole is not functioning well.

Furthermore, if there is any immediate detriment to consumers then it may grow worse over time. For example, this might arise if price flexing (or related geographic discrimination) is used to exploit consumers with high prices in areas where they face limited store choice, while driving out (and preventing entry of) smaller/specialist rivals by using deliberately low prices in more competitive areas (especially if this practice can be used in conjunction with below cost selling on known value items and individual consumer targeting through database marketing).

Accordingly, the ability of powerful retailers to apply a combination of discriminatory practices gives cause for concern that overall consumer welfare may suffer in both the short and long term.

Yet, any ability to undertake this behaviour in a detrimental way to consumers ultimately stems from the unevenness of competition across local markets; where not all consumers benefit from the same level of competitive intensity. In this situation, the absence of non-cost-justified discrimination may be preferable to its presence, but it would still not leave consumers as well off as they could expect if all local markets were to display truly effective competition. Thus, collusion concerns aside, while it is possible that a move to national pricing may offer consumers a better overall deal than one where retailers use local pricing, that deal would likely be better still if competition were intense across all rather than some or even most local markets.

Similarly, other discrimination and segmentation policies that may potentially harm consumer welfare stem from retailers exploiting consumers' lack of market knowledge (e.g. on the full range of prices and quality of products on offer) and inability/unwillingness to shop-around for bargains. To the extent that these policies facilitate retailers in competing aggressively to build up loyal customer bases at each other's expense, they may intensify competition (at least in the short term). However, where such practices concentrate on exploiting consumers' information deficit and store loyalty, through extracting consumer surplus and avoiding competition, then they may likely have adverse effects on both competitive and dynamic outcomes.

Policy Considerations

The report concludes by discussing the relevant policy considerations in regard assessing outcomes (contrasting actual and counterfactual situations), gathering evidence on the practices, determining net economic effects, and examining possible remedies to any identified adverse economic welfare effects arising from the behaviour of retailers possessing and utilising market power.

Three classes of remedies are considered: prohibitions, increasing consumer information, and reducing local market power. Each type is subject to a broad cost-benefit assessment taking into account its *feasibility* (i.e. practicality in implementing), *suitability* (in tackling the adverse effects in a proportionate manner and without giving rise to undesirable side-effects) and *acceptability* (in respect of minimising monitoring and compliance costs).

The analysis indicates that leaving competition-distorting practices alone, in the hope that any adverse effects will disappear on their own accord as the market evolves, is not an appropriate policy response. Even those practices that may have diminished recently in terms of their significance, notably price flexing, could be reintroduced if they became a profitable option for retailers that have voluntarily put them aside for the time being. Moreover, the potential for harmful effects arising from certain discriminatory practices continues to increase as the major chains grow their market share and extend their market reach.

Prohibiting practices or otherwise limiting their use may be a direct way of eliminating the adverse effects identified in a given market configuration. Moreover, such measures may be more reasonable than previously considered, given certain changes that have taken place in the market over the last few years. Nevertheless, such measures may not adequately tackle the underlying reasons for using the practices and their adverse competition effects, suggesting that retailers may seek to continue surreptitiously using prohibited/restricted practices or substitute them with other practices that individually or collectively have the same effect as the restricted/limited practices.

Alternative remedies could seek to tackle the underlying causes of the adverse welfare effects and alter retailers' incentives for using the practices in an anti-competitive manner. Consumer information remedies potentially offer one such means when they provide consumers with information and knowledge to make more informed decisions, so spurring greater consumer activism and search behaviour, and making it harder for retailers to exploit consumer price insensitivity or unawareness (e.g. on less frequently purchased items). While measures of this type have been considered before, market developments and changes in consumers' shopping behaviour and access to information sources may make these measures more reasonable than previously considered. For instance, one remedy examined in some detail may have the ability to reduce retailers' incentive to use both persistent below-cost selling and price flexing.

Another means of altering underlying incentives to adopt anti-competitive behaviour would be to consider remedies that directly impact on market structure. In particular, where the underlying problem is due to the presence of local market power (occurring generally or in pockets) arising from a lack of consumer choice over stores then remedies should be considered that reduce entry barriers (e.g. reducing planning restrictions). However, where the source of local power is a lack of consumer choice over different fascias (i.e. local consolidation in favour of particular retailers) then remedies should be considered that spread the intensity of local competition. For instance, selective store divestitures through "store swaps" could have a neutral effect on retailers' relative positions (by leaving national market shares broadly unchanged overall), but may provide an important stimulus to local competition and advance consumer store choice by ensuring a more even playing field across all the local markets that make up the UK national market. This may potentially spread the intensity of local competition across local markets more widely, while reducing retailers' incentives to use local price flexing and other forms of possible competition-reducing geographic discrimination that take advantage of uneven local competition.

Moreover, such remedies may best work in a combination, simultaneously tackling different aspects of the direct effects and underlying basis for employing competition-distorting practices, and so allowing for effective competition to apply (and more likely be sustained) across the market as a whole, to the advantage of consumers.

1. INTRODUCTION

Concerns about retailer market power have come to the fore in recent years with retail markets becoming increasingly concentrated and giant retail chains expanding to take ever-larger shares of consumers' expenditure, usually at the expense of small chains and independent retailers.[1] The continuing growth of these large chains, while offering possibilities for increasing efficiency, nonetheless, poses a challenge to competition authorities about how far these chains should be allowed to grow and how they should be allowed to operate before unfettered market power translates into or raises the prospect of clear consumer detriment – through higher prices, lower quality or less choice of goods and services, and/or reduced innovation.

With increasing market consolidation comes greater risk that large retail chains may be able to adopt practices that could prevent, restrict or distort competition in their favour and work against the interests of consumers. This could arise in different forms. For example, it may be through exploiting buyer power in such a way as to distort competition in supply markets and also undermine retail competition.[2] It may be through taking advantage of institutional features, like planning restrictions, to enhance barriers to entry or expansion in order to limit competition.[3] Yet, it could

[1] Many of these chains have widespread national and increasingly international coverage. The world's largest company, Wal-Mart Stores, may be an extreme case, employing 1.6 million people and with global sales of $312 billion, but it is not alone in possessing a commanding presence in the markets in which it operates. Each of the world's top twenty retailers has an annual turnover in excess of $35 billion, while sales for the world's top 250 retailers totalled $2.84 trillion in 2004 (Deloite, "2006 Global Powers of Retailing", Deloite Touche Tohmatsu, 2006). Moreover, large chains, particularly those operating with a "big box" format, dominate an increasingly wide range of retail product markets – see Robert Spector, *Category Killers: The Retail Revolution and its Impact on Consumer Culture*, Harvard Business School Press: Boston MA, 2005.

[2] For example, competition in supply markets may be distorted when the exercise of buyer power has a particularly damaging effect on small producers, resulting in them exiting the market or undermining their investments, potentially reducing the variety of goods available to consumers. Buyer power can distort retail competition when it enhances the competitive advantage of the major retailers over small ones, with consumers facing less choice if small retailers exit and higher prices if discriminatory terms make retail competition less effective. In the context of grocery retailing, see Roger Clarke, Stephen Davies, Paul Dobson and Michael Waterson, *Buyer Power and Competition in European Food Retailing*, Edward Elgar Publishing: Cheltenham, 2002. With examples relating specifically to UK grocery retailing, see Paul W. Dobson, "Exploiting Buyer Power: Lessons from the British Grocery Trade", *Antitrust Law Journal*, Vol. 72 (2), pp. 529-562, Winter 2005.

[3] In the context of planning restrictions, this may, for example, take the form of predatory bidding by major incumbent players on new retail sites (perhaps to build up "land banks") or using exclusivity contracts with site/mall developers to limit expansion options for new/smaller players. On how this may relate to and/or be exacerbated by buyer power, see Paul Dobson, Michael Waterson and Alex Chu, *The Welfare Consequences of the Exercise of Buyer Power*, OFT Research Paper 16, 1998 (at http://www.oft.gov.uk/NR/rdonlyres/9A4F0B82-1514-4344-9C1F-39621912E9DE/0/oft239.pdf).

also be simply through the way in which goods are marketed and sold to consumers, taking advantage of imperfect competition and consumers' lack of information or mobility and different pricing sensitivity. It is this latter possibility which is the focus of the present report and in particular the manner in which powerful retail chains can segment retail markets and adapt their retail offer in such a way as to discriminate across consumer groups or types while potentially lessening or damaging competition.

As the sector that accounts for the largest share of retail sales and generally exhibiting high levels of concentration, grocery retailing has come under close scrutiny by competition authorities in recent years. Many developed countries now have grocery retail markets dominated by just a handful of major multiple retailers. For example, the top five retailers on average now account for half of all grocery sales across the different member states of the European Union.[4] The UK grocery retail sector represents one of the more concentrated national markets with the top four retailers accounting for around 75% of grocery retail sales (and indeed 30% of all retail sales in the UK).[5] The sector is presently subject to its second market inquiry by the Competition Commission ("CC") in less than six years, during which time there has also been a number of merger investigations, notably the contemplated mergers involving Safeway in 2003,[6] as well as investigations into specific practices and market developments by the Office of Fair Trading ("OFT"). The current CC grocery markets inquiry, which began in May 2006, is focused on examining competition issues in three key areas: (a) retailers' behaviour towards suppliers, (b) retail competition in local markets, and (c) the operation of the planning regime and retailers' conduct regarding land acquisition/use.[7] This report considers the second set of issues, examining how certain retailer practices might affect competition and outcomes in the local retail markets applicable to consumers.

Thus far, most attention by the UK authorities on possible anti-competitive behaviour in local retail grocery markets has centred on two pricing practices: *persistent below-cost selling* and *local price flexing*. The former relates to pricing certain products, e.g.

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[4] IGD, "European Grocery Retailing 2005", Institute of Grocery Distribution, UK, 2005.
[5] *Id.*
[6] Competition Commission, *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc: A Report on the Mergers in Contemplation*, Cm 5950, September 2003.

frequently purchased known-value items ("KVIs") where there is high consumer price awareness, on a persistent basis with very low (and sometimes negative) gross margins. The latter relates to a retail chain pricing higher at some stores than in others based on the nature and extent of local competition. The CC found in its *Supermarkets* inquiry in 2000 that both practices were widely used and deemed them as anti-competitive and operating against the public interest when used by the leading supermarket chains, but did not recommend any remedy.[8] Six years on, and in making its reference to the CC for the present market inquiry, the OFT reported in May 2006 that both practices were still evident, if to different degrees, and continuing to be of concern in regard to their possible anti-competitive effects.[9]

These two practices have largely been considered separately. However, they are linked in a manner that is suggestive of a broader set of possible concerns. Principally, both practices are fundamentally discriminatory in nature. Consumers buying predominantly non-KVIs are paying prices that deliberately have high retail margins (compared to other products). Consumers buying from stores in locations where competition is weak or absent are paying prices that deliberately have high retail margins (compared to prices in other stores). This shared discriminatory feature in itself does not mean that the practices will be necessarily anti-competitive and against overall consumer welfare (given that there may be opposing effects on different groups of consumers). Though, when used by large chains as a means to exploit or advance market power, the practices can have the potential to distort competition to the overall detriment of consumers. This prospect becomes more likely when they are used in tandem, as a "discriminatory cocktail", with the intention or effect of undermining smaller or more specialist rivals by deliberately targeting customers in their area with lower prices on their key product lines, while raising prices in other areas and on other product lines.

[7] Competition Commission, *Groceries Market Investigation: Statement of Issues*, 15 June 2006.
[8] Competition Commission, *Supermarkets: A Report on the Supply of Groceries from Multiple Stores in the United Kingdom*, Cm 4842, October 2000 (at paragraphs 1.6-1.8).
[9] Office of Fair Trading, *The grocery market: The OFT's reasons for making a reference to the Competition Commission*, OFT845, May 2006 (http://www.oft.gov.uk/NR/rdonlyres/1A2D7FA2-FEA3-4459-9B25-4A737A20023D/0/oft845.pdf) (at paragraphs 5.1 – 5.37, providing some summary evidence on the practices and discussing possible impact on competition and final consumers).

More broadly, though, both below-cost selling and price flexing practices can be viewed as just two elements of the *micro-marketing* possibilities that grocery retail chains have to alter prices and other marketing variables (i.e. the other 3 "P's" – *product*, *promotion*, and *place* – in the so-called marketing mix) at the individual product level and individual store level. These micro-marketing possibilities suggest that the retail offer can be altered and customised in a variety of ways, some subtle and others more blatant, as a means to discriminate across different consumer groups and in the process affect market outcomes.

Here, in line with academic research in the marketing field,[10] we use the term "micro-marketing" to refer to the retail practice of customising marketing mix variables to the store-level instead of following the same policy for every store in the chain of stores controlled by an integrated, multiple-outlet retailer. At an advanced level, it entails making all decisions on the micro-scale of each individual product, in each category, for each shelf or area of the store, as well as for the store as a whole. At a more basic level, micro-marketing may simply involve determining price bands for a *zone pricing* policy, whereby stores are clustered together according to general price bands (i.e. akin to simple forms of local price flexing). Yet developments in information gathering and processing, particularly in regard to the ability to exploit scanner and expenditure survey data, mean that retailers are increasingly in a position whereby they can experiment with more sophisticated forms of micro-marketing, involving store-by-store customisation of individual product prices and even tailoring offers to individual customers. Also, and this will be critical to the points developed in this report, the approach can extend considerably beyond prices to cover a multitude of other store-level marketing elements, such as local advertising, promotions, coupons, product range, category depth, store layout, customer amenities, sales service levels, opening hours, store ambience and ultimately store size, format and precise location.

Such micro-marketing possibilities are potentially open to all retailers. However, grocery retailers are in the rare, if not unique, position of catering effectively for the whole population of the country, on a very regularly repeated basis (e.g. weekly), and on a large and wide range of purchases (with consumers filling their shopping trolleys with food and increasingly non-food items from a store that may stock in excess of 40,000 products). At the same time, consumers in this sector are very heterogeneous in terms of their preferences, willingness to spend, and location. This combination gives rise to plenty of scope for segmentation and differentiation of offers. But the realisation and effectiveness of this segmentation and differentiation is down to the unusually detailed information that the major retailers have on shoppers (in respect of individual shopping habits and preferences based on past spending history) and competitors (through detailed monitoring of their prices and retail propositions more generally), allowing them to tailor and customise their offers very precisely.[11]

The critical point here is that that documented practices like below-cost pricing and price flexing represent just "the tip of the iceberg" when it comes to the possible means that powerful grocery retail chains may have to influence and affect competition through micro-marketing – and generally apply so-called "marketing discrimination"[12].

Such means can extend to the possibility of simultaneously employing soft and aggressive approaches towards different competitors to best suit the retailer's needs and ambitions. Specifically, a major chain may seek to avoid head-to-head confrontation with other major players that could otherwise be destructive to profits. For example, this might be aided by deliberately differentiating offers, emphasising different promotions, offering distinguishing own label products, providing differing selections or package sizes of branded goods, using different "retailtainment" activities, and locating in areas where they are not immediately adjacent or in the direct vicinity of major rivals. At the same time, the same major chain may use aggressive tactics to target smaller or specialist operators to undermine their position and increase its own market share in a manner not significantly damaging to short-term profits while enhancing long-term profit prospects. For example, this objective

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[10] In particular, see Alan L. Montgomery, "Creating Micro-Marketing Pricing Strategies Using Supermarket Scanner Data", *Marketing Science*, Vol. 16 (4), pp. 315-337, 1997.

[11] For an illustration of just how detailed this information is, and how effectively it can be used to segment customers, see Clive Humby and Terry Hunt with Tim Phillips, *Scoring Points: How Tesco is Winning Customer Loyalty*, Kogan Page: London, 2003.

[12] For an extensive discussion of the topic of "marketing discrimination" in a range of different contexts, but most specifically addressing customer categorisation through using databases as marketing tools including their application to marketing techniques used in retail stores, see Joseph Turow, *Niche Envy: Marketing Discrimination in the Digital Age*, MIT Press: Cambridge MA, 2006.

might be assisted by adjusting the local offer through deliberately selling KVIs or particular categories below cost, using targeted coupons to take trade away from specific rivals, using extensive and targeted local advertising, operating extensive in-store promotions, focusing on low-cost product variants (e.g. value-line own labels), expanding amenities (e.g. in-store bakery, petrol station, and café), extending product lines (e.g. into non-food), extending opening hours, and strategically expanding the store size (e.g. extending an existing store to make it larger than local rivals).

From a public policy perspective, the array of micro-marketing opportunities that sophisticated multiple-outlet grocery retailers can simultaneously employ may make it difficult to identify and tackle the individual practices that are at the root of any competitive harm. Yet, doing so may take on added importance if it can prevent particularly damaging combinations of practices arising. In part, this may depend on the extent to which different practices serve similar effects, and so are to an extent interchangeable. It is also likely to depend on the specific market circumstances in which the practices are employed. Accordingly, a key purpose of the present report is to consider the individual and combined effects of different micro-marketing practices and then consider possible policy measures intended to avoid/lessen anti-competitive economic effects while preserving pro-competitive effects to the overall benefit of consumers.

More directly, this report seeks to present evidence, analysis and policy consideration relevant to the current groceries market investigation in particular regard to the CC's interest in discrimination practices forming part of a potentially broader business policy, of which price flexing and below cost selling may be examples, that may impact on retail competition; as stated in the CC's Statement of Issues[13]:

> We [the CC] will consider whether any such [price flexing and below cost pricing] practices may be specific examples of more general policy or policies of price discrimination. We will also consider whether, to the extent that they represent competition among some retailers, they might affect the viability of other retailers. We will consider whether some consumers may benefit from any such practices, and in particular whether any detrimental effects on consumers have arisen, or might arise, from any of the above effects.

[13] CC 2006, *supra* note 7, at point 25, page 6.

Report Outline

With these objectives in mind, the rest of the report is organised as follows.

The next section considers the different micro-marketing possibilities facing retailers, examining how the retail offer can be customised and targeted to specific consumer groups, and showing why discrimination and segmentation practices are endemic in retail marketing and extend well beyond price flexing and persistent below-cost selling.

Section 3 considers developments in UK grocery retailing in this regard, commenting on the apparent extent and nature of micro-marketing and discrimination practices in this sector, and drawing on the findings of CC's *Supermarkets* report in 2000 and supplemented with more recent evidence.

Section 4 examines in more depth the economic effects of these practices, in respect of their impact on competitive outcomes and market dynamics, drawing on insights from recent economic theory on the operation of different forms of price discrimination in imperfectly competitive settings.

Section 5 concludes the report by discussing the relevant policy considerations in regard assessing outcomes in actual and counter-factual situations, gathering evidence on the practices, determining net economic effects, and examining possible remedies to any identified adverse economic welfare effects. The discussion on possible remedies considers in broad terms the *feasibility* (i.e. practicality in implementing), *suitability* (in tackling the adverse effects) and *acceptability* (in monitoring and compliance terms) of possible remedies under three headings: prohibitions, increasing consumer information remedies, and reducing local market power.

2. MICRO-MARKETING POSSIBILITIES

At a general level, retail marketing is geared towards attracting as wide a suitable customer base as possible and encouraging *all* customers to buy more and at higher prices than might have otherwise intended to increase its revenues. This section begins by highlighting the kind of marketing strategies used by supermarkets and other retailers to achieve this aim. The discussion is intended to serve as a backdrop to the subsequent consideration of micro-marketing practices, which can be seen as fulfilling a complementary role to the retailer's the broad marketing aim.

The distinguishing feature of micro-marketing strategies is that they help the retailer to steer the sales of individual or groups of customers towards products and prices that better exploit their willingness to pay – i.e. they are designed to extract as much consumer surplus as possible, but with regard to competitive conditions and consumer attitudes. To this end, rather than treating all consumers equally, retailers may seek to segment consumers into watertight compartments through readily observable and verifiable means (e.g. their names on loyalty cards or on a personal/demographic basis such as discrimination by age, gender, employment/student status, etc). The retailer may then seek to customise its offer in a differentiated way, through its goods and prices, to each of these individual or groups of customers to capture as much value as possible.

While such a compartmentalising strategy may effectively target the right consumers with the right combinations of offers, in practice appropriate segmentation is likely to be inexact. Despite a wealth of information on consumers and the ability to segment them in a variety of ways, retailers still do not know consumers' exact intentions and disposition on visiting their stores. In these circumstances, there is a role for devising "self-targeting" strategies, whereby consumers self-select in (unwittingly) joining consumer groups by their own choice of purchasing behaviour in regard to the different product-price combinations on offer.

Possibilities for both retailer-determined and self-choice segmentation exist at both the store level, with *in-store discrimination* amongst shoppers using the same store, and at the chain level, with *between-store discrimination* amongst shoppers using different stores in the same chain. To see the range of possibilities for retailers, we separately consider in-store discrimination and between-store discrimination as these involve different practices and may also have different implications for consumer welfare.

As will become evident, the secret to the success of these practices will be in making consumers believe that they are obtaining the best value for their own circumstances. If consumers learn or believe otherwise then there may be a "consumer backlash" against the retailer. At the very least, this may undermine consumer confidence in the retailer to provide consistent good value for money and increase consumers' wariness about the retail offer, making them less free with their spending, resulting in fewer sales and less income. At worst, it may mean that customers simply decide to shop elsewhere (if they have such an option). Thus, disguising the true intent and nature of the practices can take on considerable importance in competitive environments. This is especially the case if there is the risk that consumers will become aggrieved at what they perceive as undeservedly obtaining a worse deal than others – hence accounting for retailers' effort in building consumer trust, concealing real differences, and making consumers feel that the offer they receive (even if discriminatory) is justifiable (e.g. due to cost differences or commensurate with their own effort – such as the time they are prepared to spend clipping coupons or bargain hunting).

2.1. Retail Marketing Strategies

All profit-seeking retailers can be expected to have an overarching desire to build a retail proposition that is highly attractive to consumers but, more importantly, lucrative for themselves. Retail marketing will then, not surprisingly, be aimed at building up a large and loyal customer base that is prepared to spend plenty of money, on a frequent basis. Accordingly, a key objective will be to ensure the proposition on offer appeals as broadly as possible to consumers (or at least to a targeted segment of consumers) while also encouraging their spending. The latter aspect requires a marketing emphasis on putting consumers at their ease and being less inhibited about their spending, encouraging them to purchase more than they might have originally intended, by making spontaneous as well as planned purchases. At the same time, the retailer will wish to make the shopping experience pleasant (or at least not off-putting) to encourage regular repeated custom, and cater for a wide set of (if not all) shoppers' needs to build store loyalty and deter them from shopping elsewhere.

This is quite a tall order for any retailer to put into practice. Yet, the major supermarket chains in the UK, especially the large format variety, have proven to be masters in the art and science of retail marketing to achieve these objectives.

Consumers make choices on where to shop and what to purchase, but retailers have a powerful role in influencing these choices. Where retailers choose to locate stores can considerably affect consumers' store choice, with accessibility and convenience from the consumer's perspective usually seen as highly significant determining factors in which shop to use, along with the retailer's perceived prices, product assortment, and amenities.[14] Though with the store decision made, the retailer can exert considerable influence over what customers actually purchase. Some customers may shop only in mind with a pre-determined "shopping list", but in practice some three-quarters of shoppers' purchase decisions are made only after entering the store.[15] Clearly, retailers can and do influence sales by how they operate their in-store marketing mix. Different marketing elements can come into play, each influencing the purchase decision to a different degree or in a different manner.[16]

With accessibility and convenience being highly important to consumers in their decision of where to shop, edge-of-town and suburban locations in residential areas for supermarkets offer the possibility of capturing a large pool of customers. Though, from a retailer's perspective, such locations also offer several advantages over city/town centre locations in respect of encouraging spending. First, they are more

[14] While commonly highlighted, the relative importance of these store-choice factors often varies between studies, depending on how consumer surveys are conducted (e.g. the broadness or narrowness of the attribute suggested) – see Peter J. McGoldrick, *Retail Marketing*, Second Edition, McGraw Hill: Maidenhead, 2002 (especially pages 93-95, contrasting the approaches taken by the Nielsen and the CC in 2000).

[15] See Robert Liljenwall, *Global Trends in Point-of-Purchase Advertising*, Warc.com, 2004.

[16] For instance, research on UK shoppers shows that 43 per cent of shoppers claim that point of purchase advertising (e.g. banners, promotion displays, and video adverts at shelf level) can sway their purchase decision. See "Is advertising proving irresistible?" *Marketing Week*, 8 July 2004. A recent development has been the use of in-store TV to promote goods, which is reported to boost significantly sales of advertised goods. See "The next big thing – supermarket TV", *Times*, 9 October 2004; and "Tesco TV takes on the media", *Sunday Times*, 28 November 2004.

accessible by car, both in driving and parking terms, which encourages shoppers to use their car and, in turn, facilitates the possibility of buying more than can be carried by hand. Second, because land costs are generally lower, larger sites can be developed, allowing for a large format store and plenty of parking spaces – thus providing scope for being a one-stop shop that caters for all the consumers' needs. Third, with tight planning restrictions in place, there is less likelihood of a rival store being in close proximity to draw customers away, so providing the possibility of the store operating in a local monopoly situation (with local consumers captive to a certain degree).

Yet, to make the store location and size advantage really pay dividends, large format supermarkets have cleverly adapted their offer in several ways from the very start to the end of the shopping trip. Firstly, to encourage more purchases by different types of shopper, bigger/deeper trolleys (a.k.a. shopping carts) have become prominent over recent years to cater for the large weekly shopping trip while baskets have been supplemented with shallow/easy-to-manoeuvre trolleys (intentionally designed as suitable for top-up shopping trips). Secondly, store layout is deliberately geared to encourage purchasing opportunities. With most consumers visiting supermarkets first and foremost to buy groceries on a regular basis, to encourage consumers to browse more widely, one-stop shops may place non-food ranges (clothes, books, toys, electrical goods, etc) near the entrance, so that consumers are obliged or at least encouraged to pass by these before reaching the food items (i.e. creating a maze effect).[17] Thirdly, products are displayed so as to project an image of value (e.g. using highly visible "gondola" aisle ends for special offers) and quality (e.g. only stocking perfect looking fruit and vegetables and presenting them in attractive manner[18]). Fourthly (as discussed in detail later), one-stop shops will wish to appeal

[17] Interestingly, the historical development of the market leaders, respectively, in the US and UK are the reverse of each other. Wal-Mart was originally a general merchandise store chain that started selling food to encourage customers to visit its stores more frequently (i.e. a strategy to build repeated custom and scale). Tesco was originally focused on selling groceries but has moved into non-food where retail margins tend to be higher (i.e. a strategy to increase margins and scale). With its increased emphasis on non-food, Tesco has increased the number of its largest format "Extra" stores, often by extending previously smaller sized superstores. This has, for example, recently taken place with the Tesco's store in Loughborough, where the newly extended store has a layout with non-food presented around the store entrance and food placed behind this and out of sight of the entrance (other than for snack foods).

[18] For example, some retailers (e.g. Wal-Mart in the US) go to the extreme of regularly spraying water on their fruit and vegetables displays with a fine mist leaving them covered in water droplets, so giving

to *everyone* and so offer a wide range of products, pitched at different consumers in regard to different needs and tastes.[19] This presents an opportunity to develop own label ranges as these can cover quality variants (low to high, cheap to expensive) and not just recipe variants (as branded goods manufacturers might normally offer), while simultaneously promoting the retailers' brand name and image.[20]

As well as seeking to raise sales volume, retailers will naturally wish to make high unit margins. While buyer power over suppliers may keeps the retailer's purchasing costs down, to achieve high margins the retailer will need to find ways that will allow it to obtain high prices without putting off customers (and perhaps driving them off to lower-priced rivals). To achieve this, the retailer may look to marketing tactics that play on factors that influence consumers' price sensitivity. Here, there are several effects that the retailer may seek to utilise in order to make consumers less sensitive to prices. Table 1 (below) shows a number of these effects and specific examples of how a retailer might seek to take advantage to reduce price sensitivity through using specific practices.

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them a freshly picked appearance. For other examples of retail practices relating to the stocking and displaying of such products, see Joanne Blythman, *Shopped: The Shocking Power of British Supermarkets*, Fourth Estate: London, 2004.

[19] Just how effective this can be is perhaps best gauged by the success of the market leader, Tesco, in seeking to appeal to everyone, with an ability to trade up and trade down to attract a full spectrum of consumers to its stores. As a recent article in *The Economist* put it: "If an anthropologist wanted to know what Britain was like, he would do well to take his notebook to Tesco. That's partly because it sells a third of Britain's groceries. But it is also because Tesco's customers are made up of the wealthy, middling and poor in just the same proportions as shoppers in the country as a whole" ("This sceptered aisle", *The Economist*, 4 August 2005). Other retail groups may have intentionally less broad appeal, either focusing on price conscious consumers (e.g. hard discounters) or the top end of the market (premium positioned retailers focusing on quality). Generally, though, the main one-stop shop operators seek to appeal as broadly as possible, but may differ in their effectiveness to achieve this in practice – e.g. see "Wal-Mart in Britain", *The Economist*, 28 September 2006.

[20] Promoting own label may offer further advantages by providing a bargaining lever against branded goods producers (e.g. increasing the credibility of delisting threats and demands for shelf space fees) while also allowing the retailer to appear as "the consumer's champion" when it prices copy-cat own-label goods less than the leading brands and offers cheap "no-frills" variants.

Table 1 – Reducing Consumer Price Sensitivity[21]

Effects on Price Sensitivity	Examples of Retailer Practices
1. *Reference price effect* – willingness to pay can be influenced by benchmark perceptions such as with respect to the relative cost of an alternative or prices paid previously	• Place similar items side by side to encourage confidence in value offered • Keep prices broadly consistent over time (as in an EDLP approach) to provide an indication of acceptable value[22]
2. *Difficult comparison effect* – willingness to pay can depend on the ease or difficulty of making valid comparisons	• Use packs with non-standard shapes or unique quantities to make comparisons more difficult so may make customers less price-sensitive about buying a trustworthy brand (including premium own label)
3. *Switching cost effect* – the greater the amount of switching costs, the less price-sensitive will be the customers	• Use reward card schemes and charity schemes (e.g. "computers for schools") to build loyalty and repeat custom • Create distinct store layouts and retail brand image to create psychological switching costs from familiarity and comfort • Use price comparisons with other stores to suggest no need to shop-around[23]
4. *Price-quality effect* – for experience goods consumers may use price as a signal of quality	• For goods like wine, use clear price steps as a means of communicating increasing benefits through the range to counter price sensitivity[24]
5. *Expenditure effect* – buyers become more price-sensitive when the expenditure involved represents a significant portion of overall spending and vice versa	• Price small, one-off purchases (e.g. a snack for immediate consumption), bought spontaneously and without close scrutiny, relatively high, but the core constituents of the weekly shop relatively low
6. *End-benefit effect* – with an item purchased as a component of a bigger decision, the price sensitivity will be influenced by the proportion of the item's cost relate to the whole ensemble	• Operate with keen prices on basic/core items in the weekly shop and then higher margins on additional "treats" (e.g. confectionery for indulgence)
7. *Fairness effect* – willingness to pay is strongly influenced by the perceived fairness of prices	• Set higher margins on "fair trade", "organic" or "locally produced" goods if consumers believe that the higher prices are justified by higher costs paid by the retailer (and this directly benefits the farmers and producers)
8. *Framing effect* – in line with prospect theory, consumers may place more weight on perceived losses than on equal-sized gains, so framing purchases as gains may reduce price sensitivity	• Express prices as discounts off the higher price usually charged (as with Hi-Lo promotional pricing)

[21] For further details on these effects influencing price sensitivity, see Thomas Nagle and Reed K. Holden, *The Strategy and Tactics of Pricing*, Prentice Hall: Upper Saddle River NJ, 2002; and Tony Cram, *Smarter Pricing: How to Capture More Value in Your Market*, FT Prentice Hall: London, 2006.

[22] For example, Asda's "Rollback" campaign makes use of small price cuts off previous prices to signal its efforts to keep prices as low as possible and pass on any cost savings to consumers and so earn customers' trust.

[23] For example, Tesco currently states on its carrier bags "We check over 10,000 prices in other stores* every week, so you don't have to" – suggesting to consumers that they do not need to look elsewhere to obtain the best possible prices and pointing to its own price comparison website, www.tesco.com/pricecheck, where Tesco prices are compared with those offered by the other three major UK supermarket chains, Asda, Sainsbury's and Morrisons.

[24] The same may be true even for relatively uncomplicated, frequently purchased products, e.g. sliced white bread where discrete price steps are very evident, starting with cheapest-on-display through standard loafs to the premium brands (which may be five to six times the price of the cheapest loaf). Indeed, this is a common practice in retailing, and is known as "price lining" where a limited set of specific price points are used on some goods rather than a wide variety of prices and often combined with elements of psychological pricing like using different discrete 9 ends, e.g. £1.99, £2.49, £2.99, etc. As a variant to price lining, "price clustering" may be used where prices are clustered around certain levels rather than strictly adhering to specific price points (e.g. for separate clusters of budget, standard and premium brands but where allowance is made for slight variations in the characteristics or perceived image of near substitutes).

In addition to the examples given in Table 1, certain widely observed strategies lend themselves to utilising these effects particularly well. For example, loss-leading with below-cost selling on a key component to a set of goods usually bought for a particular occasion or recipe – such as turkeys at Christmas time – may enhance store footfall and allow, through the end-benefit effect, losses to be recouped through high margins on complementary goods (e.g. stuffing, gravy, cranberry sauce, and particular vegetables and other accompaniments associated with the turkey lunch and other foods associated with the Christmas holiday period).[25] Organising the store layout to cater for different shopping needs may benefit from expenditure effect – e.g. placing high-margin snack and ready-to-eat goods near the store entrance to facilitate quick purchases but offer low margin frequently purchased products, like bread and milk, deeper inside the store to encourage top-up shoppers to purchase other goods on impulse as they pass down the store's aisles. Also, promotional practices based on offering different styles and combinations of discounts may simultaneously draw on the reference effect, the difficult comparison effect, and the framing effect. For example, a set of promotions could cover combinations of single product offers (e.g. "save *x*%", "save £*y*", "*z*% extra"), multi-buy deals (e.g. "3 for 2", "buy one get one free", "buy one buy a second half price") and cross-buy deals (e.g. "buy product *x* and get product *y* free/half price").

These examples may appear as seemingly innocuous retail practices, but each represents a form of discrimination and thereby potentially affects different consumers in different ways, and possibly competition as well. First, below-cost selling through loss leading clearly benefits those customers seeking to purchase the discounted items, but not those seeking only to purchase other products, which as a consequence of the practice are sold at higher prices than they would be otherwise. Secondly, making low margin goods less accessible may pose little problem for shoppers with plenty of time on their hands, but works against time-pressed shoppers., and thus may discriminate on a self-targeting basis. Thirdly, while single product

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25 For a theoretical analysis, see Patrick DeGraba, "Volume Discounts, Loss Leaders, and Competition for More Profitable Customers", Federal Trade Commission Economics Papers, April 2003. For some empirical analysis, see Judith A. Chevalier, Anil K. Kashyap, and Peter E. Rossi, "Why Don't Prices Rise During Periods of Peak Demand? Evidence from Scanner Data", *American Economic Review*,

offers apply a single price, the other two types of promotions are technically forms of price discrimination. Formally, multi-buy deals can be considered as representing second-degree price discrimination (offering discounts on larger purchase sizes) while cross-buy deals may represent so-called "mixed bundling" (offering separate prices for components bought individually and a discount for joint purchases) – more generally though both represent types of non-linear pricing.

Beyond these examples, there are a whole raft of ways in which grocery retailers can develop their marketing mix – covering *place*, *product*, *price* and *promotion* – to enhance selling opportunities through location and store-type, product range and mix offered, the spread and consistency of prices within categories, in-store promotion and advertising through established media (e.g. newspapers, magazines and television) or direct to consumers (e.g. through mail shots).[26] Many of these have particular application in the context of micro-marketing strategies, as we will now consider in respect of distinguishing different forms of *in-store* and *between-store* segmentation and discrimination practices.

2.2. In-Store Discrimination and Segmentation

All consumers ideally desire high quality goods at low prices (at least for themselves, if not for others). Yet, with retailers dictating the range and quality of goods on offer and their prices, it is left to consumers to respond by making their own inferred price-quality trade-offs depending on their willingness to pay and price sensitivity. Some consumers may be prepared to pay high prices for high quality while others may not. Equally, some consumers may exhibit a high degree of awareness and consciousness regarding price, others a low degree.[27]

Vol. 93 (1), pp. 15-37, 2003; and Aviv Nevo and Konstantinos Hatzitaskos, "Why Does the Average Price of Tuna Fall During Lent", Working Paper, 2005.

[26] For detailed and extensive coverage of the different retail marketing options open to retailers, see McGoldrick, *supra* note 14.

[27] Price awareness amongst consumers appears mixed, with consumers mostly focusing on relative price differences rather than absolute levels. For instance, it has been found that more than half the people leaving a supermarket cannot recall what they paid for individual items, yet consumers are better able to remember whether they were more or less expensive than similar items ("Warfare in the aisles", *The Economist*, 31 March 2005). Even so, in-store search behaviour varies, with some consumers weighing different options carefully while others less carefully, tending to be relatively price blind and unaware of the spread of prices across potentially substitute items. Moreover, store

As noted above, the broad aim of the retailer will be to try to encourage the volume and range of purchases while at the same time raise consumers' willingness to pay and reduce their price sensitivity. The retailer will wish to cater for as wide a range (and thus numbers) of consumers as possible, while extracting as much income as possible from the different types of consumers. It is with both of these objectives in mind that the retailer may consider micro-marketing opportunities to customise the marketing mix at store-level to the maximum effect.

Catering for a heterogeneous customer base with a single product at a single price will usually mean foregoing additional income possibilities. For some consumers the price will be too high and they will not buy, so sales will be lost. For other consumers, the price will be lower than the maximum level they would be prepared to pay (the so-called reservation price), so revenue per sale will be lost. Accordingly, the retailer would like to offer different prices to different consumers in a manner that would maximise sales and income (and in the process extract more consumer surplus).

However, this is not straightforward for a retailer when it is obliged (by law or convention) to display a single "ticket" price for the good, which in principle is applicable to all consumers. Thus, the retailer might look to devise means by which it can segment consumers and then make offers that apply on an individual basis (i.e. so-called "personalised pricing") or on a group basis (e.g. distinguishing consumers by an immutable and verifiable personal characteristic that separates them into groups with similar price sensitivities to effect third-degree price discrimination).

Pricing to individuals potentially offers a first-best solution (if it can amount to first-degree price discrimination and extract all consumer surplus) and may be possible to some (albeit limited) extent, e.g. using loyalty card schemes to target customers with

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loyalty and a lack of active search behaviour across competing stores means that consumers are generally unaware of rival retailers prices for the same goods, though consumers may form views (which may or may not be correct) based on advertising, word of mouth or previous experience as to the relative price levels offered by competing retailers. Again, this may not be true for all consumers – as some could be very active "cherry-pickers" searching out the best bargains across different stores – but appears to be the case for many users of one-stop shops that rely on just one retailer for their main or even entire grocery needs (see CC (2000), *supra* note 8).

discount offers through individualised coupons.[28] However, such schemes only work in one direction, i.e. with "money-off" coupons rather than "money-on" coupons[29], thus relate more to increasing sales than increasing income per sale (unless the general level of prices is inflated first). Also for practical purposes these "money off coupons" can only cover a small number of the total products on offer (given the consumer's limited capacity and willingness to carry voluminous numbers of individual coupons for every shopping trip) or only be made in respect of a broad discount (e.g. £x or y% off the total spend). Similar limitations apply to group segmentation, which may even be more imprecise in targeting offers to consumers but nonetheless may still increase income for the retailer by inducing consumers to make additional purchases.

Even so, the ability of leading supermarket retailers to target their customers very precisely should not be underestimated. Loyalty card schemes have given retailers enormous amounts of information on the purchasing behaviour of their customers allowing for very fine segmentation of offers. A good example is the use made by Tesco of its Clubcard scheme, which has some 13 million accounts covering 10 million UK households and covers around 80 per cent of Tesco sales. This scheme provides vouchers based on the customer's expenditure as a "reward" for shopping at its stores as well provides money-off coupons on specific products intentionally chosen to tempt the customer to shop more broadly. The purpose of the Clubcard programme has been described by its then director, Crawford Davidson, as providing "a mixture of an unconditional gift for past behaviour, reward for continued behaviour, and enticements for future behaviour"[30]. Yet, it is on the marketing insights provided by so much customer information that Clubcard would appear to

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[28] Alternatively, consumers can be targeted with coupons at the point of checkout based on their present purchases, with coupons applicable on their next purchases. However, this is likely to be less precise (as it is not based on a long history of purchases) and not individualised to same extent (as the coupons could be swapped between shoppers). Nevertheless, it can be seen as an effectively and relatively cost-effective means of discriminating in respect of all customers, rather than just those using loyalty cards. For some evidence of its effectiveness in practice, see David Besanko, Jean-Pierre Dube and Sachin Gupta, "Competitive price discrimination strategies in a vertical channel using aggregate retail data", *Management Science*, Vol. 49 (9), pp. 1121-1138, 2003.

[29] As Tim Harford drolly observes, "'Money-on vouchers' have never been a success" (Tim Harford, *The Undercover Economist*, Little/Brown, 2006, p. 36). Harford provides the example of Amazon and its use of "cookies" placed on the computers of previous customers so that they could be targeted with higher prices for future purchases, which resulted in considerable negative publicity for the company.

[30] Crawford Davidson quoted in Reynolds and Cuthbertson (eds.), *Retail Strategy: The View from the Bridge*, Elsevier Butterworth-Heinemann: Oxford, 2004, at page 317.

have greatest value to the retailer. It can allow the retailer to identify critical products on which to discount to provide a disproportionate effect on overall price perceptions.[31] The data can also be adapted to look at segmentation in different ways. For example, in terms of segmentation based on "you are what you eat", Tesco established consumer profiles on "approximately 15 segments, amalgamated to six high-level segments"[32].

Moreover, consumers are not just different in regard to their willingness to pay for a particular product. They can also be expected to differ according to their specific product preferences and the quantity desired. Thus to cater for all needs, e.g. as a one-stop shop might wish to do, the store should have a wide range of products, with different brands and variants on offer, and in different pack sizes. Such a wide offer would not only be attractive to consumers, it assists the retailer in devising discriminating strategies, e.g. giving coupons to some consumers for certain products, and to other consumers for other products with the intention of encouraging all consumers to expand their range and number of items bought.

Where customers in different segments cannot be easily or usefully separated into watertight compartments, then utilising self-targeting strategies may be a useful alternative. However, an immediate problem is that with all shoppers free to purchase goods at the same ticket price then lowering a price to one segment (i.e. those consumers otherwise reluctant to buy the product) would be visible and open to customers in other segments (i.e. those who derive greater value from the product and would anyway make purchases at the higher price). In these circumstances, operating with separate products, covering different quality images, different varieties and different brands, becomes very useful in allowing consumers to self-select in a manner that can benefit the retailer. For example, the range may cover lower-priced

[31] Humby and Hunt (2003), *supra* note 11, give the example of Tesco, using segmentation analysis based on Clubcard data, in introducing selective price cuts to combat Asda by focusing on products bought by the most price-sensitive segment (e.g. budget own-label margarine) rather than widely purchased across all customer segments (e.g. bananas). On the overall strategic importance of the Clubcard scheme for Tesco, see Andrew Seth and Geoffrey Randall, *Supermarket Wars: Global Strategies for Food Retailers*, Palgrave Macmillan: Basingstoke, 2005, especially pages 108-9.

[32] Crawford Davidson quoted in Reynolds and Cutherbertson, *supra* note 30 at page 317. For further details on the nature and extent of consumer profiling and how Tesco uses this information, see Humby and Hunt, *Id*. Also, see "Tesco's success puts Clubcard firm on the map", *Sunday Times*, 19 December

"fighting brands" which appeal to the price-sensitive segments, "standard brands" for segments balancing price and quality, through to "premium brands" that appeal to most discerning and quality-conscious segments.

Such a multi-tier approach to product choice in respect of perceived quality differences is particularly discernible with regard to private label offerings. For example, Tony Cram in his book *Smarter Pricing* describes the three-tier own brand policy of Tesco, the UK's leading supermarket chain, in the following terms:[33]

> Tesco have three own-brand ranges. The 'Tesco' standard version is a mid-market offering. The 'Tesco finest' is a premium-priced luxury proposition with sales of £600 million its own right. 'Tesco Value', launched in 1993, is a price-fighting offer. How does Tesco prevent leakage between the segments, and in particular prevent buyers of standard and premium ranges from trading down? Clive Humby and Terry Hunt (2003) give an insight in the book *Scoring Points*. Tesco has carefully designed the recipe and taste of their Value Margarine so that it meets the basic needs of price-constrained shoppers who would otherwise buy elsewhere. The taste is not sufficiently palatable for more sophisticated tastes. By offering different products, Tesco capture the custom of the low-price payers and also capture the value from the high-price payers.

Indeed, like other supermarket chains, Tesco has moved beyond just three tiers of own label for many product ranges, offering in addition "organic" and "fair trade" products at premium prices with intended appeal respectively to health-conscious and ethically-minded consumers.

However, a problem for retailers is to encourage the "right" consumers to buy the "right" goods, i.e. pick those products that allows for effective surplus extraction based on willingness to pay for particular quality-price combinations. This is made all the more difficult if quality distinctions are not particularly clear based on the ingredients alone. In these circumstances, consumers may have to be "guided" in their decisions. One means may be through the quality of the ingredients or taste (as with the above quoted example on value margarine. Another way may be through

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2004. For details on the kinds of information stored and used on individuals, see "Tesco stocks up on inside knowledge of shoppers' lives", *Guardian*, 20 September 2005.

[33] Cram, *supra* note 21, at page 56, with the reference in the quote to Clive Humby and Terry Hunt, *supra* note 11.

different and distinctive packaging. Here, the quality of the product can be signalled not just through price differences but also through presentation differences.

One might consider retailers as wanting to make all their goods and packaging to look and taste as attractive as possible, to give a consistent high quality image. However, to emphasise differences in quality, and corresponding differences in pricing points, retailers may deliberately choose not to do so and instead opt to make some products look and taste attractive and others distinctly less so.

The comparison is most stark with the attractive and expensive looking packaging afforded premium own label items in contrast to the unattractive and cheap looking packaging used for budget own label goods, which, as Tim Harford[34] describes, "seem to be packaged for the express purpose of conveying awful quality". The reason for this practice is simple. Even though designing more attractive packaging for budget own label products would not cost much to the retailer, it would defeat the object of putting off customers who are willing to pay more and would otherwise buy the bargain product unless the retailer makes some effort to discourage them. This is therefore a form of deliberately sabotaging the appearance of the product and then relying on conspicuous-consumption and snob effects to ensure that more quality-conscious and snooty consumers are put off buying such products and instead opt to buy higher-priced variants with better packaging, and thus in the process self-target price increases on themselves.[35]

Nevertheless, deliberately sabotaging packaging quality, or indeed the product quality itself, may come at the cost of diminishing the price at which consumers will pay for

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[34] *Supra* note 29, at page 51.

[35] The analogy is with the nineteenth centre French economist Emile Dupuit's comment on the reasons for extreme segmentation of fare classes on early railways:

> It is not because of the few thousand francs which would have to be spent to put a roof over the third-class carriage or to upholster the third-class seats that some company or other has open carriages with wooden benches… What the company is trying to do is prevent the passengers who can pay the second-class fare from travelling third class; it hits the poor, not because it wants to hurt them, but to frighten the rich… And it is again for the same reason that the companies, having proved almost cruel to the third-class passengers and mean to the second-class ones, become lavish in dealing with first-class customers. Having refused the poor what is necessary, they give the rich what is superfluous.

(Source: translation by R.B. Ekelund, "Price discrimination and Product Differentiation in Economic Theory: An Early Anaysis", Quarterly Journal of Economics, Vol. 84, pp. 268-278, 1970.)

the item to the extent of not affording the retailer a suitable return. If the product is perceived as unduly shoddy, it may encourage customers to shop elsewhere. In these circumstances, it can pay the retailer to use branded goods as the key reference point in promoting its own label ranges. In particular, it can put its own label ranges (and thus its own name) in a positive light by ensuring that high quality brands provide a "pricing umbrella" under which its own label variants are priced.[36]

In addition to differentiating products in clear *quality* steps to appeal to different consumer segments, similar benefits may arise from differentiating offers in clear *quantity* steps, offering different pack sizes with different prices per measurement unit. This can allow the retailer to differentiate its pack prices and allow consumers to self-select according to their preferences, with the retailer usually offering discounts[37] as size becomes larger (i.e. second-degree price discrimination). So, consumers with plenty of storage space may bulk buy, while other consumers may be obliged by their own circumstances to take smaller packs (and higher per unit prices in the process).

Finally, retailers may be able to induce customers to self-target themselves at a broader level. As an example, Tesco operates a voluntary club-membership scheme whereby approximately 1.5 million customers have signed up to join a "club" and receive mailings with product information and offers related to a particular interest or lifestyle (e.g. Baby & Toddler Club, Kids Club, and World of Wine). These clubs may, in turn, allow for further segmentation – e.g. the Healthy Living Club covering, for example, special interests like eating healthily, giving up smoking, and alternative health. This self-selection offers the retailer the opportunity to target these customers

[36] On how retailers can strategically use own label ranges, see Lars Thomassen, Keith Lincoln and Anthony Aconis, *Retailization: Brand Survival in the Age of Retailer Power*, Kogan Page: London, 2006.

[37] Occasionally, surcharges on size may apply but these are usually part of the retailer's strategy of mixing up retail offers to take advantage of the difficult comparison effect listed in Table 1, or relying on consumers' usual association with larger sizes having discounts but not checking when making the actual purchase (i.e. consumers duped by not being sufficiently observant). However, this is a risky strategy if applied regularly, as this will increase the chances of detection by consumers, who then may cease trusting the retailer to the same degree and instead become more conscious and sensitive about prices.

(through direct mailings) with particular offers while more generally encouraging their loyalty to, and earning repeat custom with, the retailer.[38]

2.3. Between-Store Discrimination

As well as facing a heterogeneous customer base at store level, multiple retailers can also expect different stores to face different consumer profiles. Consumers may exhibit a relative high willingness to pay and be relatively price insensitive in some locations, but be the opposite for other locations. In these circumstances there may be opportunities for the retailer to tailor its retail offer to best exploit these local, store-by-store differences – i.e. through geographic discrimination based on the store location.

However, it may not only be consumer demand differences that might encourage customising the retail proposition. Local competition may vary from one store to another across the retail chain – in some areas there may be plenty of local rivals, in other areas very few. Equally retail costs may differ from one store to another – due to differences in store size, local land/rent costs, local wage levels, in-store amenities, and stock replenishment/distribution costs. For example, one would expect average/unit costs for a convenience store to be greater than a large-format supermarket, given that the latter will benefit from significant economies of scale and scope compared to the former.

With local differences in consumer demand, competition and/or operating costs, retailers may desire to set different price levels according to the local circumstances by deviating from an average level up or down – the practice of local price flexing. Thus in areas where willingness to pay is high, competition is weak or absent, and/or operating costs are high, the retailer may be tempted to raise prices. The converse holds where willingness to pay is low, competition is intense, and/or operating costs are low.

[38] See Crawford Davidson quoted in Reynolds and Cutherbertson, *supra* note 30 at page 317, where it is observed how this club approach works together with the Clubcard data to provide Tesco with “very powerful segmentations”. For further details on the Tesco clubs, see Humby and Hunt, *supra* note 11, chapter 12.

Yet, these combinations offering clear-cut circumstances may not be prevalent. Instead, retailers may be faced with considering trade-offs. For example, in rural areas and socially deprived urban areas, with average incomes below the national average, willingness to pay may be less than in more affluent, urban areas. However, it may be that competition is less in the former. So, a tension may exist between offering low prices to encourage spending or offering high prices to exploit the lack of competition in rural/poor urban areas, and vice versa in affluent areas.[39] The general rule for the retailer is to set the higher prices to that group of customers most willing to pay them, rather than who can best afford to pay them.

A further factor will be the retailer's perspective on how it wants to meet local competition. In some locations, it may wish for an accommodating position, and look to price in a way that does not trigger a hostile response from rivals. In other locations, it may look for ways to eliminate or at least undermine the competition and instead position itself with an aggressive pricing policy. Here, the retailer may seek to combine local price flexing and below-cost selling with predatory intentions.

Even so, there are different ways to tailor the local offer beyond merely setting different broad price levels, by adjusting other elements in the marketing mix:

- local advertising – adapted by intensity and type (e.g. different types of media, flyers and direct mail to target local households)
- in-store advertising – the amount of point of sale advertising (e.g. adverts on trolleys, banners, product displays, and in-store television adverts)[40]
- local promotional offers – e.g. money-off coupons sent to local consumers (to build custom)
- in-store promotions – e.g. the local amount and extent of discounts and multi-buy offers
- product range – e.g. extent of food and non-food ranges
- category depth – range of brands and varieties and quality spectrum offered

[39] Also, the balance of costs could go either way. Land and employment costs may be cheaper in rural/poor urban areas, but distribution costs and unit costs (due to slower stock turnover) may be higher.

[40] For further examples and details how selling in-store advertising can be a lucrative business for major supermarkets, see "Tesco TV takes on the media", *Sunday Times*, 28 November 2004.

- quality emphasis – focus on value brands or premium brands
- store layout – pattern and positioning of product ranges, shelving and aisles
- customer amenities – whether to operate with in-store features like a café and site features like extensive car parking space and petrol station
- sales service levels – e.g. the number of checkouts and shop assistants
- store ambience – whether recently renovated/redecorated as well image in terms of colours, lighting, flooring, product mix and retailtainment features (e.g. cooking demonstrations)
- opening hours – restricted, standard, extended or full 24 hours

In particular, we can observe that there is a wide array of retail features that can be readily adjusted and customised for local stores without undermining the overall retail brand image. In other words, these can be undertaken in a relatively subtle fashion so that local customers may be unaware of the different offer they are receiving compared to customers using other stores run by the same chain.

Furthermore, whereas setting higher price levels to one group of consumers might be seen as quite flagrant discrimination, adapting other elements in the marketing mix might not raise the same degree of consumer resentment.[41] For instance, consumers might be less aware and less immediately concerned by differentiated local offers through adjusting levels of local advertising, local category depth, and product range choices (e.g. whether to orient the store more towards "fighting lines" like generics

[41] Even so, there may be ways for the retailer to undertake profitable micro-marketing pricing strategies that have broadly neutral consumer welfare effects. For example, Montgomery (1997) suggests adjusting store-level prices while holding the average category price and revenues at a constant level. Alternatively Chintagunta *et al* (2003) propose using balanced price discrimination strategies across stores that generate additional profits without appropriating "too much" consumer surplus. Even with these restrictions, Montgomery's (1997) analysis indicates that micro-marketing pricing strategies could increase gross profit margins by 4% to 10% over a uniform pricing strategy, feeding through to an increase in operating profit margins of 33% to 83%. Chintangunta *et al.* (2003) find that a constrained store-level pricing policy could yield additional gross profits of 5.6% to 7.4% over uniform pricing (compared with an increase of 9.6% to 16.3% for unconstrained store-level pricing). With such margin potential at stake, it is not surprising that retailers will be very interested in exploring micro-marketing opportunities. See Montgomery, *supra* note 10; and Pradeep Chintagunta, Jean-Pierre Dube, and V. Singh, "Balancing profitability and customer welfare in a supermarket chain", *Quantitative Marketing & Economics*, Vol. 1 (1), pp. 111-147, 2003.

and budget own labels or more towards "premium lines" like premium own labels and up-market brands[42]).

Equally, a chain's stocking and replenishment policy may vary across its stores, even when selling ostensibly the same items at the same prices. For instance, a chain might for some of its stores deliberately limit the shelf-space or even availability of certain items, e.g. promotional or value lines, in order to induce customers to purchase alternative, higher-margin items. This may even go to the extreme of deliberately stocking-out or not rapidly replenishing certain items, relying on customers to pick an alternative product rather than face the inconvenience of shopping elsewhere or encouraging them to make another store visit sooner than envisaged.[43]

Also, beyond the more readily adaptable elements of the market mix, ultimately the retailer has local choice over the store size, format, precise location, and store amenities. Thus investment decisions (rather than merely tactical decisions) can be considered on a local basis to suit local market conditions.

This adaptability in investment decisions also carries over to the choice of retail brand that a multiple retailer wants to operate with in local markets. For example, a retailer may operate with its main retail brand name in markets where it wants to portray good

[42] For instance, Tim Harford (*supra* note 29, at pages 41-42) contrasts the store layout and product ranges between two Sainsbury's stores; one in Tottenham Court Road in the heart of London's prosperous West End, and the other in Dalston (one of East London's less prosperous neighbourhoods). Harford observes that in the former store, greater emphasis was placed on expensive goods with inexpensive variants like budget own label either not stocked or kept apart in the store, while in the latter store a wider range of variants were stocked and also placed side by side. He claims the effect was to "target the whole Tottenham Court Road store at shoppers who are indifferent to prices, but to aim the Dalston store at shoppers with a sharper eye for a bargain – while of course giving any price-blind Dalston shoppers plenty of opportunity to show their true colours" (p. 42).

[43] This is clearly not a strategy that can be consistently applied on the same item, since it may induce customers to visit elsewhere in search of their favoured product/brand. However, when apparently randomly stocked out, the customer may assume that this is his/her bad luck and then simply choose on that occasion to pick an alternative product or make another visit, perhaps on a different day and/or at a different time. Such is the typical extent of the dependency of the consumer on his/her primary store, once familiar with the layout, then it would likely take repeated stocking out on multiple products with limited alternative choices to induce the him/her to go elsewhere. This is made all the more likely when the store is the only one in the near vicinity. It is also more likely when there are alternative choices that might be perceived as having similar quality levels as the stocked-out favoured product, e.g. a premium own label as an intended direct substitute for a leading brand. In these circumstances, shoppers may more readily switch to the alternative without too much thought or bother. For instance, studies have shown that shoppers spend no more than six seconds on average looking for a specific brand before they settle for an alternative (e.g. see "Warfare in the aisles", *The Economist*, 31 March 2005).

value, but not expose this brand in markets where it wishes to adopt a different competitive position. For example, it may want a more aggressive image through operating a hard discount approach or it may want to take a less competitive approach. For instance, the retailer might not wish to expose its main brand in local situations where it wants to set high prices, with limited product ranges, no own labels, and with limited store investment, such as it might wish to use in socially deprived urban areas. It may also wish to do this in areas where it is already present with its main retail brand and where this differentiated offer would allow it to segment more effectively the local market, e.g. by providing a different branded convenience store in the vicinity of its own large supermarket operating with its main brand name.[44]

More generally, we might expect the multiple retailers to change their store format or deliberately open a new store format to reflect local competition, e.g. using a high-price convenience store format when there is an absence of large superstore controlled by a rival or hard discounter. They may also add or take away amenities (such as a petrol station) as suits their competitive needs. Clearly, the bigger the chain, and the more extensive its regional/national coverage then the more likely it is to have options in choosing between different store sizes (ranging from convenience store to hypermarket), location types (e.g. standalone edge of town, neighbourhood cluster, town centre, etc.), and scope for simultaneously serving both primary (one-stop) and/or secondary (top-up) shopping needs.[45]

In short, multiple retailers have plenty of scope for adjusting their local offer beyond simply by the prices offered on individual products. They can adapt a whole host of elements in the marketing mix to effect geographic discrimination and induce

[44] For example, Tesco operates two retail sites in Loughborough separated by less than a quarter of a mile: one a “Tesco Extra” superstore, the other a “One Stop” convenience store (which has no obvious appearance of being part of the same retail group). The One Stop store appears to have a sufficient size and attractive position that might (otherwise) suit conversion to a Tesco Express. However, the present arrangement of operating two separate retail brand names may suit Tesco and ensure that consumers self-target in their store selection (according to their convenience or one-stop-shop needs) and pay different prices for the same goods in the process. Indeed, the One Stop store in Loughborough is currently (mid-November 2006) being refurbished, indicating Tesco’s continued investment in this retail fascia.

[45] For example, in the CC 2003 investigation of the contemplated mergers involving Safeway, Asda claimed that Tesco price more aggressively near its Asda outlets through varying its formats. See CC (2003) *Safeway* merger report, *supra* note 6, at paragraph 2.96.

consumers to self-target in their store choice in a manner that can be expected to be advantageous to the retailer. Local price flexing is just one element of the micro-marketing mix that can be deliberately tailored. However, the extent to which this practice and other local retail adjustments can be effective in raising profits is likely to depend fundamentally on the nature of competition. Capturing value from consumers is more straightforward when they have fewer alternatives and the retailer has "scarcity power" with a relatively captive customer base that it can exploit to good effect. In these circumstances, we should expect retailers not only to adapt their local offer to best capture value from consumers, but also with an eye to how best tackle competition both in the short term and longer term.

3. DEVELOPMENTS IN UK GROCERY RETAILING

This section considers the developments in UK grocery retailing regarding pricing and other practices in the local retail markets served by retailers. Our starting point is a brief description of the market structure, drawing on the distinction made between the markets for "one-stop shopping"[46] served by large format outlets and "secondary shopping"[47] served mainly, though not exclusively, by mid-range and convenience stores.[48] We consider the key market characteristics at the time of the CC inquiry concluded in 2000 and then look at subsequent developments in the sector leading up to the present CC inquiry – principally, with the leading supermarkets consolidating their share of grocery sales and moves by some of the major chains into the convenience store sector. We examine how these market characteristics and developments may lend themselves to particular opportunities for micro-marketing practices and consider the scope that these may have to yield anti-competitive effects.

3.1. Sector Composition

Grocery retailing represents the largest retail sector in the UK, with total sales from grocery outlets around £120 billion and grocery sales around £95 billion.[49] Four retailers – Tesco, Sainsbury, Asda and Morrison/Safeway – presently dominate the national market, accounting for 75% of sales of grocery items (i.e., food and drink, cleaning products, toiletries and household goods), and indeed 30% of all retail sales in the UK.[50] These four supermarket retailers have primarily positioned themselves as "one stop shops", operating with very wide product ranges in large format stores. As such, they jointly account for over 90% of grocery sales for stores exceeding 1,400

[46] The CC's 2000 report (*supra* note 8, at paragraph 2.26) defined "one-stop shopping" as "the shop for the bulk of a household's weekly grocery needs, carried out in a single trip and under one roof".

[47] "Secondary shopping" is distinguished from "one-stop shopping" by virtue of its greater use of other (typically smaller) types of grocery stores, a different product mix (e.g. containing proportionately more perishable items like bread and milk), and a lower average basket spend.

[48] The UK authorities distinguish these broad types of shopping behaviour from the separate classification of grocery retail stores where these are typically into three categories: one-stop shops over 1,400 sp metres, mid-range stores between 280 and 1,400 sq metres, and convenience stores less than 280 sq metres. They also acknowledge that grocery stores of very different sizes can exercise a degree of competitive constraint on one another, with this possibly being asymmetric (e.g. large stores serving both one-stop and secondary shopping needs, but small stores usually serving only secondary shopping needs). See OFT, *supra* note 9, paragraphs 2.1-2.9.

[49] *Id*, paragraph 3.5.

sq metres – currently viewed by the UK competition authorities as the critical size distinguishing one-stop grocery shops, serving primary shopping needs, from smaller stores catering predominantly for secondary shopping needs (e.g. for “top-up” and “convenience” grocery shopping).

In addition to the “Big 4” supermarket multiples, there are other multiple retailers (integrated under single ownership) including smaller supermarket chains (e.g. Somerfield, Waitrose, Marks & Spencer, and Booths) and “discounters” (e.g. Aldi, Lidl, Netto and KwikSave). The rest of the grocery retail sector is made up of symbol groups (with a common fascia but fragmented ownership, e.g. Budgens, Londis and Spar), co-ops (operating as consumer co-operatives with a common fascia), and independents (independently owned stores and not operated with a wider symbol fascia).

3.2. CC’s Findings in 2000

The major grocery chains operate on a national or broad regional level in the UK. However, there is considerable variation in regional and local market shares and concentration levels. Table 2 provides some summary evidence, based on the findings of the CC in its *Supermarkets* inquiry concluded in 2000.[51] In particular, high levels of local concentration[52] were found in more rural areas[53] (notably in Scotland and Wales) and certain urban areas where a proliferation of stores from the same chain existed[54]. In addition to market structure differences, consumer income

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[50] *Id*, paragraphs 3.5-3.6.

[51] Note that the table shows the separate positions of Morrison and Safeway prior to their merger in March 2004.

[52] In determining the degree of local concentration and the extent of store choice facing consumers at the local level, the UK competition authorities have taken the pragmatic approach of examining local markets in respect of drive times between stores or choice in postcode areas (as indicative of the store choice on offer to consumers depending on where they live or work). For UK supermarkets, the CC (2000, *supra* note 8, at Appendix 6.3) identified that out of 1,700 stores surveyed, 175 stores were found to have a “monopoly” or “duopoly” status in local catchments (in respect of 10-minute drive times in urban areas and 15-minute drive times in rural areas around each of the stores). However, when restricted to competition between the major “one-stop-shop” grocery retailers and with 10-minute drive times, then 627 out of the 1,700 stores were found to have “monopoly” or “duopoly” status.

[53] This is perhaps not surprising with rural areas being less densely populated and store replenishment being more difficult in remote areas (i.e. in the absence of a nearby regional distribution centre).

[54] For instance, the British media has designated a number of areas as “Tesco towns” (e.g., see “Supermarkets to carve up high street”, *Sunday Times*, 19 February 2006). As market leader, Tesco

levels also differ from region to region (tending to be higher in the southern part of the UK) and from district to district (tending to be higher in urban areas as opposed to rural areas[55]), suggesting the presence of variation in local consumer demand and willingness to pay.

With differences in both local competition and local demand conditions, it might be thought that most retailers, assuming they had the technology and wherewithal, would seek to take advantage of opportunities to set prices differently from store to store on micro-marketing pricing grounds. In particular, retailers might set higher prices in areas where local competition was limited and/or average income levels were high, while setting lower prices in areas of more intense local competition and/or low average incomes. However, the CC (2000) found an almost even split between those firms that adjusted prices on a local basis and those that adopted uniform prices across all their stores. Of the fifteen main supermarket chains operating in the UK at that time, seven were found to vary prices from store to store based on local competition and demand conditions – which the CC termed "local price flexing" – while eight used national pricing, with no local variation in prices.

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presently is reported as having the largest market share in 67 of the 120 postal districts in the UK, with more than 40% of the market in 14 districts, and more than 45% in five towns ("Power of 'big four' revealed in new figures", *Guardian*, 10 November 2005). At the more disaggregated postal code level, it has been reported that out of the 1,452 postal areas of the UK, Tesco was found to have "an almost total stranglehold" on the retail food market in 108 areas, while accounting for over 50% of grocery spending in a further 104 areas ("Tesco profits feed fears of a stranglehold", *Sunday Times*, 18 April 2004).

[55] Even so, the range of income per capita varies considerably within both urban and rural areas. For instance, the CC (2000, *supra* note 8 at Appendices 13.4 and 13.5) found that for a sample of urban areas, at postcode sector level, income per capita ranges from as low 35% to as high as 155% of the national average.

Table 2: Market Characteristics in UK Grocery Retailing, 1999

Main UK grocery retailers	*General character & pricing policy* [56]	*Total grocery stores*	*National Market Shares*		*Regional Market Shares*		*Local Concentration*	
			All grocery stores (%)	*Grocery stores > 1,400 sq m (%)*	*Highest regional share (12 broad UK regions) (%)*	*Highest broad postcode share (120 narrow regions) (%)*	*% stores in local monopoly (10/15-minute drive time)*	*% stores in local duopoly (10/15-minute drive time)*
One-stop shops								
Tesco	Value-led Hi/Lo	642	23.0	28.5	46.5	53.6	6.0	10.3
Sainsbury	Hi/Lo	424	18.7	24.8	35.9	56.7	0.5	4.1
Asda	EDLP	227	12.2	16.8	24.8	46.8	0.0	3.1
Safeway	Hi/Lo	498	11.5	13.8	28.4	51.0	9.2	9.8
Morrison	EDLP + deals	95	3.9	5.4	21.9	45.0	0.0	4.2
Other chains								
Somerfield / Kwik Save	Hi/Lo Soft Discount	1,442	9.8	3.1	17.2	30.0	NA	NA
M&S	Premium	294	4.9	2.2	12.1	NA	NA	NA
Waitrose	Premium	119	3.0	2.5	9.0	NA	NA	NA
Aldi	Hard Discount	219	1.4	0.0	3.1	NA	NA	NA
Lidl	Hard Discount	173	0.9	0.0	2.6	NA	NA	NA
Netto	Hard Discount	120	0.7	0.0	2.1	NA	NA	NA
Budgens	Hi/Lo	177	0.7	0.0	0.9	NA	NA	NA
Iceland	Specialized/deals	770	3.0	0.0	0.3	NA	NA	NA
Booth	Premium	24	0.2	0.1	1.3	NA	NA	NA
Co-operatives	Hi/Lo	1,920	6.4	2.8	7.7	NA	NA	NA

Source: adapted from CC (2000; Tables 5.2, 5.3, & 8.30, Appendices 5.2 & 7.1)

Table 3 shows the extent and character of local price flexing identified by the CC. Individual product prices were found in some retailers to vary considerably (by as much as 100%), but average prices differed across each chain by less than 3%.[57] The CC investigated the basis on which local pricing operated, identifying the critical factors influencing store-level pricing (as shown in the final column of Table 2). For the seven retail chains that did vary prices, both differences in local demand (in respect of income or regional effects) and local competition (in respect of local

[56] These are broad interpretations of each retailer's position in 1999, based on the CC's summary of their pricing policies. These positions may have changed in subsequent years. In particular, the one-stop shop retailers appear to have moved to a more common hybrid value-based position supported with promotional offers in the form of multi-buy and discount deals, with the consequence that prices have become very similar across these retailers (with many products displaying no difference in prices or possibly just 1 penny differences across the current Big 4 retailers).

[57] While the percentage variations might appear fairly small, the monetary sums involved can be quite significant given the size of the sector. For example, the CC (2000, *supra* note 8, at paragraph 7.124) found that for the largest retailer, Tesco, customers in its lower-price stores saved between £10.5 and £25.9 million a year over the prices charged in higher-price stores. It may also be the case that had the CC taken a broader sample size then the basket price range may have been found to be wider than the figures reported in Table 2 – which would be more consistent with evidence from other sectors and in other countries (as we detail below in the next section of the report).

market power or facing particular price-focused competitors) were found to be important in determining the price band applied to individual stores and the variation in prices across the chain of stores.[58] Cost elements (like differences in store size) were also found to play a role, but not so significantly as to explain the full extent of store-to-store price variation.[59]

Table 3: Local Price Flexing by UK Grocery Retailers, 1999

Store Fascia	*Price-flexed products [60] (%)*	*Widest price range on any price-flexed product*	*Average price range for price-flexed products (%)*	*Basket price range across stores (sales weighted) (%)*	*Identifiable store-level price bands (1=Uniform)*	*Factors influencing store-level pricing [61]*
Tesco	8.5	43.4	19.2	1.69	5	R/Y/E/D
Sainsbury[62]	NA	NA	NA	NA	2+	S/R/E
Asda	0	0	0	0	1	-
Safeway	59.5	31.0	4.3	1.09	3	M/E/D/S/R
Morrison	0	0	0	0	1	-
Somerfield	23.7	100.0	6.3	0.20	10	E/S/M
Kwik Save	2.3	16.1	9.8	0.79	3	D/M
M&S	0	0	0	0	1	-
Waitrose	0	0	0	0	1	-
Aldi	0	0	0	0	1	-
Lidl	0	0	0	0	1	-
Netto	9.9	23.5	13.7	0.001	2	R
Budgens	64.5	62.0	9.8	3.04	5	Y/D/M
Iceland	0	0	0	0	1	-
Booth	0	0	0	0	1	-
Co-op	33.7	57.0	6.7	0.54	4	R/S/M

Source: adapted from CC (2000; Tables 7.2 & 7.3, Appendices 7.5 & 7.8)

[58] US evidence, e.g. the findings by Hoch *et al.* (1995) and Chintagunta *et al.* (2003) in relation to Dominick's Finer Foods ("DFF") (a large supermarket chain in the Chicago area), shows that zone pricing is mostly driven by differences in local consumer characteristics rather than by local competition or costs, which may be more reflective of the more open competitive structure in the US without the same institutional impediments like planning restrictions evident in the UK. See Stephen J. Hoch, Byung-Do Kim, Alan L. Montgomery, Peter E. Rossi, "Determinants of store-level price elasticity", *Journal Marketing Research*, Vol. 32(1), pp. 17-29, 2005; Chintagunta *et al.*, *supra* note 30.

[59] For instance, the CC undertook detailed analysis on the relative profitability of stores operated on different price tiers by Tesco and Sainsbury. In both cases, the CC found that the higher prices in their higher price tier stores were more than was required to meeting higher operating costs, or indeed higher asset costs – CC (2000), *supra* note 8, Tables 8.31 & 8.32 and paragraphs 8.109 & 8.114.

[60] This is based on a basket of up to 200 common products with prices collected from up to 60 stores for each party on January 28, 1999.

[61] Store-level pricing factors identified by CC empirical analysis: R = regional effect (e.g. lower in North, higher in South); Y = local average income; E = local presence of EDLP retailer (Asda or Morrison); D = local presence of hard discount retailer (Aldi, Lidl or Netto); S = store size; M = local market share.

[62] Sainsbury did not provide the CC with the requested price data, but instead provided a complete list of stores that might selectively offer lower prices (with 111 of its 422 stores on a lower price tier).

We can also note that whether a retailer uses local or national pricing does appear to be closely linked with its general pricing policy. Broadly speaking, those retailers that employed promotional "Hi/Lo" promotional pricing used local pricing, while EDLP, hard discount, and premium positioned retailers used national pricing. We can further note, from Table 2, that of the five leading one-stop-shop chains, it is three chains that had the highest proportion of their stores in local monopoly/duopoly areas that used local pricing (i.e. Safeway, Tesco, and Sainsbury).[63]

In its assessment of local price flexing, the CC concluded that the practice was anticompetitive and operated against the public interest when employed by the major one-stop-shop chains (i.e. Tesco, Sainsbury and Safeway).[64] Nevertheless, the CC could not identify, what it considered, a suitable remedy and no subsequent action was taken, leaving retailers free to continue using the practice.[65]

In regard to other discriminatory behaviour, the CC identified *persistent* below cost pricing as being widely practised and linked to an emphasis by leading retailers on "focused competition" (characterised by keen competition and low prices on KVIs and corresponding less competition and higher prices on non-KVIs). Full details on the extent of the practice are not documented in the CC's report. However, the leading retailers appeared to operate with approximately one hundred to two hundred items at any one time being sold below purchase cost (i.e. with negative *gross*

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[63] Furthermore, in its 2003 inquiry into the Safeway contemplated mergers, the CC's analysis of the extent of store choice in relation to existing Safeway stores found that of its 349 shops that were of sufficient size to be classed as one-stop shops, 128 were in monopoly or duopoly situations and some 92 further stores were in situations of three-way competition, indicating that some 63% of its main stores were in a situation of restricted competition. See CC (2003) *supra* note 6, Appendix 5.5.

[64] On competition effects, the CC concluded that the practice "distorts competition in the retail supply of groceries in the UK in that it tends to focus some elements of price competition into localities where particular lower-priced competitors are present and away from other areas and contributes to the position that a majority of grocery products are not fully exposed to competitive pressure" (CC 2000, *supra* note 8, paragraph 2.406).

[65] The CC determined that it could not identify a remedy to the detrimental competition and welfare effects that would be proportionate in effect and in regard to the regulatory cost. In particular, the CC ruled out recommending the imposition of national pricing (on grounds that this would not allow for differential pricing based on legitimate factors such as regional cost differences). Similarly, it ruled out recommending a requirement than any price differences between stores should be broadly related to costs (on the grounds that this would be impractical to implement and regulate). Other options were considered and also rejected. See CC (2000), *Supermarkets* report, *supra* note 8, at paragraphs 1.6-1.8. Nevertheless, some of the retailers have voluntarily moved to uniform pricing according to formats (e.g. Tesco and Sainsbury), presumably as they see the main store-to-store cost differences being associated with store format/size differences rather than any particular differences based on locality.

margins).[66] In seeking to assess the effects of the practice at the retail level, the Competition Commission identified some 370 common product lines with gross margins of less than 5% (indicating likely negative *net* margins). These represented some 6% of supermarket sales and nearly 11% of convenience store sales. The products differed according to the duration of below-cost selling, with short-term promotions at below-cost levels tended to be well-known brands and some commodity produce, while *persistent* cases of below-cost selling tended to be budget/economy own-label lines including bread, butter, sugar, and other staple items.[67]

The CC's finding in relation to persistent below cost selling was that it distorts competition in the retail supply of groceries in the UK. Specifically, the practice damages smaller/specialist grocery outlets by "channelling competition so intensively that losses are incurred that have to be made in higher prices charged on other products".[68] Furthermore, the CC found that the practice operates against the public interest when used by the major one-stop-shop operators (Asda, Morrison, Safeway, Sainsbury and Tesco) because of its likely predatory effect, contributing to the closure of smaller/specialist stores, thereby reducing consumer choice and amenity, as well as "costs to consumers generally, when they buy other, higher-priced, products from which the below-cost prices are subsidized".[69] Yet again, though, the CC could not identify a suitable remedy that would be proportionate in effect and avoid considerable regulatory cost, leaving retailers free to continue using the practice.[70]

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[66] Asda, for example, reported to the Commission that on a sample date it had 215 products priced below cost. Similarly, Tesco reported that on a sample date it had 160 products priced below cost, noting that over the period 1997-9 it had a total of 1,065 products priced in this manner. A sample date figure for Sainsbury is not given but the company reported that it generally operates with around 3% of its 36,000 product lines at below cost price levels and that a significant minority (25 per cent) of its budget own-label products is priced in such a manner. Sainsbury also reported the gross losses on these items amounted to 0.28% of annual turnover of which 37% was accounted for by products sold below cost on a persistent basis.

[67] Some retailers, including Safeway, Sainsbury, and Morrison, informed the CC that a number of budget own-brand products were often sold below cost. The emphasis on staple products for below-cost selling is also borne out by case law from other countries, for example in Spain and Germany. See Paul Dobson, *The Economic Effects of Constant Below-Cost Selling Practices by Grocery Retailers*, report prepared on behalf of the Federation of Bakers, July 2002.

[68] CC 2000, *supra* note 8, paragraph 2.387.

[69] *Id*, paragraph 2.393.

[70] *Id*, paragraph 2.565.

3.3. Post-2000 Developments

Following the CC inquiry in 2000, and even in the absence of any intervention, the pattern of pricing practices in the sector has changed noticeably in recent years. This change has not so much applied in respect of below-cost selling, which appears just as prevalent as before, still being extensively used by the major retailers and still applied predominantly to KVIs.[71] However, there has been a very noticeable change in the use of price flexing.

While price flexing has continued to be used by some of the smaller chains, by 2004 all the major one-stop-shop chains had ostensibly adopted a policy of setting national prices across their supermarkets. By 2003, both Sainsbury and Tesco had voluntarily moved away from store pricing based on location.[72] Furthermore, in March 2004, Morrison acquired Safeway and set about converting all the latter's supermarkets into the Morrison format, in the process abandoning Safeway's store-by-store promotional pricing policy in favour of its national pricing policy.

Nevertheless, while ostensibly abandoning price flexing, several retail groups continue to operate differential pricing by store size or format. For example, both Tesco and Sainsbury may operate a national price list applicable across all their respective large supermarkets but this may be different to the prices set in their small stores (e.g. their separately branded convenience stores as compared to their supermarkets). Similarly, the same retailer may operate with different fascia having different prices (e.g. Tesco Express and One Stop convenience stores, or Morrison supermarkets and Safeway convenience stores). Even Marks & Spencer ("M&S"), which has in the past consistently operated a uniform pricing policy, has abandoned this policy with the development of its "Simply Food" specialist stores, differentiating prices based on store size and location.

In all these cases, retailers may claim that the resulting price differences are based entirely on store operating cost differences (e.g. higher overheads and staffing costs).

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[71] See OFT (2006), *supra* note 9, at paragraphs 5.9 – 5.18 (finding that, across the big four retailers, around 1.8% of product lines were sold with gross margins less than 5%, representing some 3% of total grocery sales).

[72] See CC (2003), *supra* note 6, at paragraphs 5.36 and 5.37.

However, the possibility of the retailers taking advantage of different degrees of local consumers' willingness to pay and local competition should not be ignored, especially in view that the store size/format decision may itself be influenced by such local factors.[73]

Moreover, even for chains that have publicly committed themselves to operating with national price lists, this commitment may not rule them out from offering price cuts (or their equivalent) at selected stores by other means. One such way has been to offer local shoppers vouchers which when redeemed at the store can allow for a percentage discount or fixed amount off the total bill over a certain level (e.g. "spend £X and get £Y off"). Other ways have been to offer certain multi-buy offers (e.g. "buy *x* get *y* free") only at selected stores or to lure customers to selected stores through the inducement of earning extra loyalty card points.[74]

In addition, it is evident that a public commitment to a national price list might not apply to all goods sold. In particular, most, if not all, supermarkets that operate petrol stations set local fuel prices, which might vary quite significantly from one store to another, even over quite short distances.[75]

[73] The possibility that price differences may not be entirely cost-driven has been considered in media articles, e.g. "Tesco makes city shoppers pay a premium", *Daily Mail* (London), 13 September 2003; and "M&S rip-off in stores in the South", *Daily Mail* (London), 12 September 2003. Furthermore, there are disputed figures about the extent of price differences. For example, Tesco claims that its Express stores "sell products at an average of 2 to 3 per cent higher" than its other stores – see Tesco *Main Submission to the Competition Commission (CC) Inquiry into the UK Grocery Retailing Market*, paragraph 7.12 (available at www.competition-commission.org.uk). A separate price survey, though, suggests a wider price gap, averaging around 5% higher for Express stores, and a substantially higher average of around 25% higher for One Stop compared to prices in Tesco supermarkets – see "Tesco is accused over high prices", *Sunday Times*, 12 February 2006.

[74] For details and some examples, see OFT (2006), *supra* note 9, at paragraphs 5.19 to 5.25.

[75] With the possible exception of Asda, supermarket groups tend to set petrol prices relative to local competitive conditions – e.g. low or high prices depending on whether Asda or another petrol discounter is near or distant. This appears to be borne out by the data available from the price comparison website www.petrolprices.com, where, for instance, the absence of a local Asda can mean that petrol price may be set higher. This author's own observation was that for much of 2006, though not all the time, petrol prices in Loughborough appeared to be around 2p to 3p a litre (approximately 2% to 3.5%) higher than in the neighbouring cities of Leicester, Derby and Nottingham – each only around 15 miles away. It may or may not be a coincidence that in all three of these cities there is at least one Asda store, unlike in Loughborough where the main one-stop shops are operated by the other three main chains, i.e. Tesco, Sainsbury and Morrison. Moreover, there does not appear to be a suitable cost explanation for such a price differential, given the accessibility of the town and no obvious factors that would suggest higher operating costs compared to the nearby cities.

At a broader level, though, one might question why leading players decided to abandon or at least curtail local price flexing in favour of (ostensible) uniform pricing. It was presumably a profitable practice, so a decision to change pricing policy may have had to do with retailers seeking alternative benefits, such as enhancing public relations or possibly even considering potential strategic advantages. For instance, in the case of Tesco and Sainsbury, it might be no coincidence that such a move occurred at a point where the two retailers were on the trail of major acquisitions – both seeking to acquire the Safeway chain as well as a number of convenience store chains. While prevented from acquiring Safeway, their respective moves to acquire different convenience store chains were subsequently cleared by the Office of Fair Trading without a referral for a CC investigation.

In contrast, Somerfield, a significantly smaller retailer but one that continued to flex prices locally, was subjected to a full CC inquiry on the purchase of 115 stores from Morrison (as part of the latter's required store divestments following its merger with Safeway).[76] The CC concluded that Somerfield must divest 12 of these stores on the grounds that the acquired stores would represent a substantial lessening of competition in the local markets served, which could result in higher local prices due to Somerfield's price flexing policy, and a possible reduction in the range, quality and/or service offered (e.g. shorter opening hours).[77]

A concern must therefore be present that the price flexing practice may return once these retailers are no longer on the acquisition trail[78] and the regulatory spotlight is off

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[76] See Competition Commission, *Somerfield plc and Wm Morrison Supermarkets plc: A report on the acquisition by Somerfield plc of 115 stores by Wm Morrison Supermarkets plc,* September 2005.

[77] *Id*, at paragraph 7.52.

[78] Here retailers might be wise to the fact that the absence of price flexing makes it harder for competition authorities to prove, or at least argue with sufficient certainty, that prices will likely rise with a merger that concentrates some but not necessarily all local markets. This appears to have been a key downfall for Somerfield, where the CC could argue that higher local concentration could allow the retailer to set higher prices through its price flexing policy in specific locations. However, the UK authorities (and thus presumably legal counsel advising merging companies as well) will be aware of other instances where retail chain pricing policy might have been the undoing of a merger. Perhaps most well known is the *Staples/Office Depot* merger case in the US, where the Federal Trade Commission used evidence of local price variation by the two chains to show that a narrow product market definition (covering only office stationery superstores) and narrow geographic definition (covering separate metropolitan areas) were appropriate, and that the retailers took advantage of less competition by raising prices, thus indicating that prices would rise post merger with a reduced number of local competitors – *Federal Trade Commission v. Staples, Inc. and Office Depot, Inc.*, Civ. no.97-701 (TFH), 1997. In essence, the FTC was able to show that this "3 to 2" merger would likely raise prices in local markets based on existing prices being significantly higher in monopoly and duopoly

them[79]. This seems all the more likely if local concentration continues to rise and instances of local monopolies and local duopolies increase, enhancing opportunities for profitable discrimination.[80]

Moreover, despite claims that commitments to national pricing are intrinsic to the retailer's proposition (either as a matter of company history and reputation[81] or due to retail brand competition and national advertising[82]), as the CC acknowledged in its

local markets than in triopoly markets (with average prices varying by as much as 16% depending on the extent of local competition). For a case summary and the significance of the economic evidence used, see Serdar Dalkir and Frederick R. Warren-Boulton, "Prices, Market Definition, and the Effects of Merger: Staples-Office Depot (1997)", in J.E. Kwoka and L. White (eds.), *The Antirust Revolution: Economics, Competition and Policy*, 3rd Edition, Oxford University Press: Oxford, 1999.

[79] For instance, there might be perceived strategic advantages in operating a national pricing policy while exclusive dealing arrangements in the acquisition or rental of store sites are under investigation. For example, back in 1997, Dixons Group, the UK electrical goods chain, appears to have successfully argued with the OFT that even though it may have operated certain exclusionary agreements with property developers, to exclude key rivals from being located in the same retail parks/malls, that it would not be in a position to exploit geographically constrained consumers where it might have a local monopoly as a result of its national pricing policy, and so consumers as a result would not be made worse off. See for instance "OFT investigates Dixons over 'strong arm tactics'", *The Times*, 20 May 1997, "Kalms short circuits the competition", *The Times*, 20 May 1997, and "Dixons faces OFT inquiry", *Financial Times*, 20 May 1997. Nevertheless, the logic of this defence appears flawed in several respects. First, there is an implicit assumption that a single retailer could provide all the needs of consumers in a local monopoly situation when in fact consumers might have a strong preference for obtaining specific products that only rivals stock and/or the service that rivals offer. Second, even though a national pricing retailer would not exploit individual monopoly markets through price discrimination, clearly the more monopoly markets that the retailer held then the greater the likelihood would be of it setting higher national prices. Third, the argument does not acknowledge the competitive and cost disadvantages which rivals might be placed under as a result of being denied access to key sites (again allowing for the possibility of the retailer raising prices at the national level).

[80] Moreover, this rise in local concentration may not be merely due to store openings and closures. It could, for example, be due to space expansions at existing stores. For instance, Sainsbury's submission to the current CC inquiry claims that new store space accounts for 70 per cent of Tesco's growth in sales since 2000, largely through the development of Tesco Extras and the expansion into non-food. It is further claimed that as a result of Tesco's space expansion, it now accounts for more than 50 per cent of all one-stop store takings within the drive-time isochrones around over 50 per cent of its one-stop stores, and that Tesco holds a monopoly or duopoly position in isochrones around 40 per cent of its one-stop stores.

[81] For example, Asda (owned by Wal-Mart) informed the CC that, in respect of charging the same prices for its products in every one of its stores, "it would be commercial suicide for it to move away from its highly publicized national EDLP pricing strategy and a breach of its relationship of trust with its customers, and it would cause damage to its brand image, which was closely associated with a pricing policy that assured the lowest price always" (CC 2003, Safeway merger report, *supra* note 6, paragraph 5.38). Similarly, Morrison informed the Commission that it used a national pricing policy since "adopting a policy of local prices would be contrary to its long-standing marketing and pricing policy, it would damage its brand and reputation built up over many years and would adversely affect consumer goodwill, as well as being costly to implement and manage" (CC 2003, *Id.*, paragraph 5.40). However, as reported above (in note 62), M&S has abandoned its long-standing uniform pricing policy and instead recently moved to adjusting prices according to store format and location.

[82] For example, in its non-confidential submission to the current CC inquiry, Tesco claim that: "Brand competition, including national advertising is part of the competitive process, as is the use of the internet by Tesco to publish its prices at all stores across the country. The value of the brand in quickly eroded if a retailer cannot deliver its offer consistently across the country. The brand equity, in effect,

Safeway merger investigation in 2003, all supermarkets are able to switch to pricing locally if there is a profit opportunity.[83]

In the meantime, even though price flexing may be downplayed, retailers may still, as discussed above, have plenty of scope to tailor the local offer by other means. This reinforces the view that retail markets in this sector are indeed local, and not national (as some retailers might claim).[84] As previous CC inquiries have shown, 10-15

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conveys a promise to customers about what they can expect at every store in the country." However, as evident from Tesco's ability to price differently across different store formats without apparently damaging its brand value, this does not appear to be a convincing argument in respect of guaranteeing uniform pricing. Moreover, grocery shoppers do not search across different stores in the same chain to check that prices are identical (so would not know if they were or not the same across the chain). Also, consumers do not as a habit draw up an extensive shopping list for a weekly trolley load of goods by first checking the prices on the internet and then going to the store to make sure that these are exactly as stated on the internet before making their purchases (so would not know if national advertising was a true reflection of all prices in the store). More generally, the Tesco argument does not pass the critical test that for a pricing commitment to apply and be binding it should visible, verifiable and irreversible. In contrast, retailers in other sectors like Argos (as a catalogue-based general merchandiser) and IKEA (as a catalogue-based furniture and furnishings retailer) might more readily satisfy this test as they commit to national price lists through expensive investments in their printed catalogues available to all UK consumers (that once issued cannot be cheaply altered). Also, prior to visiting these stores, consumers may well check up in the catalogue or on the internet the prices of the goods they are searching for (as they may be high valued, one-off purchases), so there would be damage to their brand reputation if these retailers did not deliver on the prices stated in the catalogues. However, this is not to say that these retailers could not tailor the local offer in other ways (e.g. by store location, amenities, car parking, product range stocked, etc.) or indeed from one country to another.

[83] For instance, the CC concluded that "in our view [there is] no reason to conclude that national pricing must or will inevitably continue in the future. Given the scope for local pricing, we would expect firms to pursue whichever … strategies … [were] most profitable in the prevailing circumstances of the market" (*Safeway* merger report, *supra* note 6, at paragraph 2.98).

[84] For instance, in respect of main party submissions made to the CC for its current investigation, Asda agrees that the relevant market is local as customers shop locally and are prepared to travel only small distances, and similar arguments are put by M&S and Sainsbury. In support of the line taken in this report, Waitrose point to competition being local by virtue of "the various activities that all stores engage in to a greater or lesser extent to enhance their local offering and win local market share". They state that "examples of such activities, their relative importance varying by store format and by operator, include price variation, local discount and voucher schemes, the enhancement of stores through refurbishments, local advertising and the fostering of local community relations". In stark contrast, Tesco maintains that retail markets are national on the basis that "virtually all the catchments overlap" and a "chains of substitution" effect arises across the UK, matched by retailers adopting "national strategies relating to pricing, branding and range that barely vary in different local areas". However, as previous CC and OFT inquiries have shown, grocery shopping behaviour is predominantly highly localised, the UK population is essentially separated into distinct cities, towns and villages, and stores do have discretion to (and in fact do) adapt their local offer in respect of the dimensions by which retailers usually compete (e.g. through prices, quality, range and/or services on offer), all suggesting that it is appropriate to consider retail markets to be local. Moreover, even if retailers did not choose to vary their offer locally, it should be evident that increased local concentration and restricted local choice would allow retailers to raise their general price level (due to a general weakening of the competitive constraint facing retailers) – i.e. just because retailers might not flex prices does not mean that no consumer harm might arise from an increase in local concentration. More generally, a local market definition appears reasonable for many low value, everyday items like groceries, toiletries, and other fast-moving consumer goods ("FMCGs"), along with petrol, cigarettes and alcohol, where consumers only normally travel short distances in making shopping trips. In

minute drive times might be appropriate for large supermarkets (CC 2000 and 2003)[85] and 5-10 minute drive times for mid-size stores (CC 2005)[86]. In the case of convenience stores, local catchment areas and thus local market size may be even smaller (with shorter drive/walk times).[87]

contrast, it may not apply either to higher value shopping goods (like expensive electrical items and other consumer durable goods) where search behaviour may be much more extensive or to goods sold mainly through direct selling routes, like the Internet, when this integrates local markets into a becoming a single national or even global market.

85 CC (2000), *supra* note 8; and CC (2003), *supra* note 3.

86 CC (2005), *supra* note 76.

87 For example, see the OFT decisions in respect of Tesco/T&S (9 December 2002) and Tesco/Adminstore (5 March 2004), taking the view that the relevant convenience-store markets are very local in nature (e.g. with store catchment around a one-mile radius from the store). However, it is also suggested that in specific areas competition might be more regional in nature, e.g. within the greater London area (i.e. inside the M25 orbital motorway). This is a contentious view since it is clear that, even in large conurbations like London, convenience store chains can have significant discretion over the individual store offer, given that convenience purchases may typically involve little consumer search behaviour and store choice tends to be made only between very geographically close stores. For example, Harford (*supra* note 30, at pages 40-41) observes M&S charging prices on certain goods 15 per cent higher at its Liverpool Street Station store compared to its Moorgate store, when the two stores are just around 500 metres apart in central London. In other words, it is not clear that a chain of substitution argument holds in large conurbations. More plausible is that market size may vary quite critically depending on precise location and how, when and why consumers make store visits (e.g. by driving or walking, in rush hour or leisure time, for urgent or non-urgent purchases), giving rise to the possibility of breaks in the supposed chain of substitution.

4. ECONOMIC EFFECTS OF MICRO-MARKETING PRACTICES

4.1. Economic Welfare Considerations

By their nature, discriminatory practices can be expected to affect different consumers in different ways. Usually, some consumers may benefit, while others may lose. Yet, competition can have a significant impact on both the direction and extent of effects. Indeed, it is conceivable for competitive circumstances to arise where all consumers gain through lower prices (where discrimination results in so-called "all-out competition"). Equally, it is conceivable for competition to work the other way and lead to the situation where all consumers lose through higher prices (where discrimination results in so-called "all-out price gouging").[88]

In the more usual situations, where some consumers gain while others lose in terms of the value they obtain, then the public attitude towards the type or basis of discrimination may depend significantly on who gains and who loses. Lower prices for low-income consumers, higher prices for high-income consumers may be viewed as socially acceptable (e.g. as something akin to progressive taxation). The reverse may not be, but is a distinct possibility with between-store discrimination. For example, where competition is absent or limited in rural areas or socially deprived urban areas with consumer incomes generally below the national average, then retailers may target consumers with higher prices or provide worse service than in their stores in more affluent but equally more competitive areas.[89] Similarly, with in-store discriminatory pricing, below-cost selling may benefit less affluent consumers when the practice is focused on basic/essential items. However, there may be general

[88] On the relevant economic theory showing such possibilities, see Lars A. Stole, "Price discrimination and imperfect competition", in Mark Armstrong and Robert Porter (eds.) *Handbook of Industrial Organization Vol. 3*. Elsevier: Amsterdam, forthcoming; and Mark Armstrong, "Recent developments in the economics of price discrimination", Working Paper, University College London, February 2006.

[89] This may not just apply to the UK, where concerns exist about higher prices and poorer service, quality and range in so-called "food deserts" (e.g. see http://www.fooddeserts.org). Several US studies point to this outcome. For an early survey, see A.J. Parker, "A review and comparative analysis of retail grocery price variations", *Environment and Planning*, Vol. 11, pp. 1267-1288, 1997. In addition, there may be a broader set of social issues, such as store accessibility that benefit mobile, car-owning consumers who can access large format stores in edge of town locations but work against elderly or less mobile consumers who have to make do with visiting neighbourhood or town centre stores – e.g.

public concern with the practice if it entails retailers compensating for loss-making sales with higher (non-cost-justified) prices on other products which results in low prices for highly-processed/low-quality goods but higher prices for healthy/organic foods.[90]

Nevertheless, while these issues take on a distributional, ethical and/or social dimension, the economics emphasis is normally placed on the overall efficiency of the practices taking account of the net balance of effects; i.e. looking at whether weighted average prices rise or fall and whether total sales (in volume terms) rise or fall. The former will take on considerable importance in respect of overall consumer welfare, the latter in respect of overall societal economic welfare (i.e. taking account of the net effects for industry and consumers).

In addition to overall effects on prices and quantities, consideration needs to be given to product and service choice, quality and range and whether these are increased or reduced by discriminatory practices both in the short term and long term (also with a view to the impact on future innovation).

4.2. Impact on Competitive Outcomes

There is now a substantial economics literature examining the economic impact of price discrimination. This literature shows the net effects depend fundamentally on the market circumstances – the exact nature and character of demand, competition, and costs.[91] In particular, the literature emphasises that price discrimination itself can affect the intensity of competition – in some circumstances intensifying it, in other cases softening it. Specifically, the recent literature on price discrimination in oligopoly goes beyond considering which consumers may gain and which may lose,

see F.M. Kelley and A.J. Parker, "A study of retail accessibility for older people", Centre for Regional Studies, National University of Ireland, Dublin, 2005.

[90] For examples on how and why supermarkets retail organic foods with high profit margins, see Harford, *supra* note 29 (especially pages 42-45).

[91] For details, again see the survey articles by Stole and Armstrong, *supra* note 88. In addition, and with a focus on the antitrust implications, see Mark Armstrong, "Price Discrimination", Working Paper, University College London, October 2006.

to look at how the nature and operation of the discriminatory practice impacts on the market overall.

A particularly useful distinction to emerge from this recent literature has been between what Kenneth Corts terms "best-response symmetry" and "best-response asymmetry" situations, in which, respectively, competitors hold the same or opposite view as to whether separate markets/segments are "strong" or "weak".[92] In the latter, clear results can emerge where all prices may fall with "all-out competition" or may rise with "all-out price gouging", depending on the extent to which rivals aggressively target consumers with tastes more naturally inclined towards their rivals.[93] Moreover, the finer the degree of market segmentation and the more precise the information on consumers, in the limit offering personalised pricing (i.e. first-degree price discrimination), the more exaggerated the net effect on prices may become.[94] Similar analysis also applies to discrimination via the issuing and distribution of coupons.[95]

[92] Here "strong" markets/segments are those where consumer willingness to pay is high and/or competition weak, so one would expect price discrimination to result in higher prices in such markets compared to "weak" markets where willingness to pay is low and/or competition is intense. The labels "best-response symmetry" and "best-response asymmetry" relate to how rivals optimally react to each other's pricing decisions across the separate markets/segments – in the former case, rivals' price changes go in the same direction (so, with discrimination, all prices rise in strong markets, and fall in weak markets; in the latter case, price changes go in the opposite direction so that equilibrium prices may individually or jointly rise or fall across markets with price discrimination). See Kenneth S. Corts, "Third-Degree Price Discrimination in Oligopoly: All-Out Competition and Strategic Commitment", *RAND Journal of Economics*, Vol. 29, pp. 306-323, 1998.

[93] All-out competition arises when each firm is under intense competitive pressure to ensure that consumers more favourably inclined to themselves are not taken away by rivals, while at the same time aggressively targeting (with low prices) consumers more favourably inclined towards rivals. In contrast, with all-out price gouging, competitors are less concerned about targeting rivals' strong markets, and more inclined to focus on securing their own "home" markets, with the result that competition is dampened.

[94] For example, see Greg Shaffer and Z. John Zhang, "Competitive one-to-one promotions", *Management Science*, Vol. 48 (9), pp. 1143-1160, 2002; Yuxin Chen and Ganesh Iyer, "Consumer addressability and customized pricing", *Marketing Science*, Vol. 21 (2), pp. 197-208, 2002; Qihong Liu and Constantinos Serfes, "Quality of information and oligopolistic price discrimination", *Journal of Economics and Management Strategy*, Vol. 13 (4), pp. 671-702, 2004; and Anindya Ghose, Vidyanand Choudhary, Tridas Mukhopadhyay and Uday Rajan, "Personalized pricing and quality differentiation", *Management Science*, Vol. 51 (7), pp. 1120-1130, 2005.

[95] On using coupons to discriminate between groups of consumers across stores in oligopoly (i.e. *inter*-store geographic discrimination), see Greg Shaffer and Z. John Zhang, "Competitive coupon targeting", *Marketing Science*, Vol. 14 (4), pp. 395-416, 1995; and Helmut Bester and Emmanuel Petrakis, "Coupons and oligopolistic price discrimination", *International Journal of Industrial Organization*, Vol. 14 (2), pp. 227-242, 1996. On using coupons for *intra*-store discrimination (such as issuing customised coupons at the point of sale), see David Besanko, Jean-Pierre Dube and Sachin Gupta, "Competitive price discrimination strategies in a vertical channel using aggregate retail data", *Management Science*, Vol. 49, (9), pp. 1121-1138, 2003.

4.2.1. Opposite Views on Strong vs. Weak Markets

The kind of situation when best-response asymmetry might apply is where competing retailers each have a base of very loyal customers (which are unwilling to switch a rival's store unless offered very attractive terms), but they compete effectively over a set of marginal consumers (e.g. those living mid-way between competing stores) by offering them targeted discounts (e.g. through home-delivered coupons) on a general basis (i.e. not just in selective local markets). The more aggressive the competition is for these marginal consumers, then the more likely it is that the net effect, at least in the short term, will be to lower average prices compared to the situation where there is no discrimination in the local market.[96]

If, in contrast, the competitive focus is on retaining loyal customers through discriminatory inducements rather than aggressively targeting marginal consumers or trying to poach the rivals' loyal customers, then average prices may be higher than in the absence of discrimination.[97] In other words, in economic welfare terms it would be better, as a trigger to more intense competition, if retailers "rewarded" marginal (infrequent) customers with lower prices rather than loyal (regular) customers – something which goes against the current practice and emphasis on loyalty reward schemes and also against discounts and multi-buy offers if their prime purpose is to keep loyal customers happy rather than lure bargain hunters to the store intent only on cherry-picking the best offers.[98]

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[96] Here, the longer-term concern would be if one or more of the players were able to price in a predatory manner to drive rivals out of the local market, in which case average prices might rise afterwards (as discussed below in sub-section 4.3.2).

[97] See the examples and discussion provided by Stole, *supra* note 88, on all-out price gouging (arising where "rent extraction" effects dominate "business stealing" effects). Corts's analysis, *supra* note 92, is important since some writers have wrongly ascribed best-response asymmetry situations as necessarily implying that price discrimination in oligopoly intensifies competition. For example, based on simple Hotelling-type models with unit demand and uniform distributions of consumers and certainty over consumer locations, this is the incorrect stance taken and applied to antitrust issues by J.C. Cooper, L. Froeb, D.P. O'Brien, and S. Tschantz, "Does Price Discrimination Intensify Competition? Implications for Antitrust", *Antitrust Law Journal*, Vol. 75 (2), pp. 327-373, 2005; and Thomas P. Gehrig and Rune Stenbacka "Price discrimination, competition, and antitrust" in *Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005. In fact, the net outcome is likely to depend critically on the precise market circumstances. For instance, for empirical evidence on a situation characterised by best-response asymmetry where price discrimination is found to be pro-competitive, see A. Nevo and C. Wolkram, "Why do Manufacturers Issue Coupons? Empirical Analysis of Breakfast Cereals", *RAND Journal of Economics*, Vol. 33 (2), pp. 319-339.

[98] This observation has also been made in the context of loyalty card schemes operated in the US, where it is suggested that the emphasis by grocery retailers is saving "most valuable purchasers" ("MVPs") and pushing away "cherry pickers". For example, see R. Shulman, "Picking Your MVPs",

4.2.2. Shared Views on Strong vs. Weak Markets

The contrasting situation of best-response symmetry is where the firms share the *same* view on what constitutes a strong market (indicating potential for higher prices) and a weak market (suggesting lower prices). For example, this applies to local retail markets where retailers' positions are more dependent on market conditions that affect all players (e.g. the area is affluent rather than poor or competition is limited as opposed to intense) than on idiosyncratic differences (say, due to consumer preferences for particular chains altering considerably across areas). Accordingly, this situation may be more relevant to the consideration of the impact of price flexing, where retailers set higher prices in strong markets (i.e. high demand and/or weak competition) and lower prices in weak markets (i.e. low demand and/or strong competition).

Economic analysis here suggests that the net effect of the discriminatory practice in relation to average prices (across the country) may depend quite delicately on the exact market circumstances and how they differ from one locality to another. However, the analysis in this area points to the greater prospect of overall consumer welfare loss the greater is the disparity in the intensity of competition across the local markets. For instance, with some local markets near perfectly competitive and others approximating local monopolies, then any uniform price set would have to be relatively close to the localised price that would otherwise apply in the weak markets (through concern that the retailer would otherwise lose much of its custom to a rival undercutting its price). Thus, under uniform pricing, consumers in the weak markets would not lose much surplus (and the price rise they would face would be relatively small), but consumers in the strong (near monopoly) markets would gain considerable surplus (as price would be set much closer to the competitive level).[99] This is clearly a situation that competing retailers may wish to avoid. Price discrimination is attractive to the retailers in these circumstances as its offers a means of disentangling competitive restraints on pricing, by extracting significantly more profits from the

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Progressive Grocer, 1 March 2005; and Jack Neff, "Why Some Marketers Turn Away Customers", *Advertising Age*, 14 February 2005.

[99] See Paul W. Dobson and Michael Waterson, "Chain-store pricing across local markets", *Journal of Economics and Management Strategy*, Vol. 14 (1), pp. 93-119, 2005; and Paul W. Dobson and Michael Waterson, "Competition and Consumer Welfare in Retail Oligopoly", presented to the 33rd Annual

strong (less competitive) markets while not losing much in the weak (more competitive) markets.[100]

In these terms, the significant presence of local monopoly and local duopoly situations in conjunction with substantially more competitive local markets (e.g. as indicated in Table 3 above) is thus likely to give rise to a situation where price flexing overall harms consumers by raising average prices compared to when retailers nationally price. In other words, in terms of the balance of opposing effects, the opportunity to exploit local monopoly power will likely mean disproportionately higher prices in these "strong" markets than any lowered prices from increased ability to meet local competition in "weak" markets. This effect might normally (but not necessarily) be expected to outweigh any countering effect that uniform pricing might have to dampen competition.[101] Even so, in contrasting outcomes, account also needs to be taken of firms' incentives to continue serving local markets if they are prevented from using their preferred pricing policy.[102]

This position should be contrasted with the line taken by the OFT in making the reference for the present CC inquiry: "In many situations, price discrimination (both across products and across locations) can play a key role in a genuinely competitive

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Conference of the European Association for Research in Industrial Economics, Amsterdam, August 2006 (available at http://www.earie2006.org).

[100] Even so, circumstances may exist where the distinction between what amounts to a strong or weak market is less clear cut, e.g. when some local markets exhibit high demand but more intense competition (e.g. dense affluent urban markets) than other local markets with lower demand but less intense competition (e.g. sparse poorer rural markets). In such circumstances, then there may be a strategic advantage for the retailers committing to uniform prices as this could soften competition sufficiently to raise overall profits, but may (though not necessarily) work against consumers' (aggregate) interests. For the individual retailer, this would mean forgoing high prices and high profits in the local markets where it has greater demand or monopoly power and instead leveraging this strong position across all its markets to raise prices in those markets where the intensity of competition or lower demand otherwise makes them low. It entails sacrificing some local profits, but with the benefit of softening competition more broadly sufficiently to raise firm profits overall. See Dobson and Waterson (2006), *Id*. On related analysis, examining how agreements amongst rivals to reduce price discrimination across separate markets can benefit both themselves and consumers, with respectively higher joint profits and higher aggregate consumer welfare, see Ralph A. Winter, "Colluding on relative prices", *RAND Journal of Economics*, Vol. 28 (2), pp. 359-371, 1997.

[101] For details on such potential trade-offs and how uniform pricing might be used strategically to dampen competition, see Dobson and Waterson (2006), *Id.*

[102] For instance, where a firm faces a mixture of very highly competitive markets and local monopolies, then if it were to face a uniform pricing constraint (e.g. due to a prohibition on price flexing) it might do better by withdrawing from the competitive markets altogether, and just setting high prices in the monopoly markets. Accordingly, there are conceivable circumstances where a ban on local pricing might exacerbate local monopoly power (i.e. if withdrawing from competitive markets significantly increases concentration in those markets).

process, to the benefit of consumers overall".[103] The OFT also state more pointedly in respect of price flexing that: "In some circumstances, local price competition, where there is no predatory behaviour arising from the abuse of a dominant position in an area, could benefit rather than harm consumers – that is, the existence of price flexing could be a characteristic of a well-functioning competitive market".[104]

Here, economic theory would only support these statements if price discrimination intensified competition – as more likely might (but not necessarily) happen with best-response asymmetric situations (where retailers take opposing views on whether a particular local market is strong or weak). However, with price flexing being better approximated by best-response symmetry (i.e. where retailers take the same view on whether a particular local market is strong or weak),[105] then regardless of any predatory behaviour, economic theory would suggest that price discrimination would usually be expected to harm overall consumer welfare (unless there is some unusual demand effect[106] or a competition-dampening effect arising from uniform pricing commitments[107]). Moreover, the actual presence of this particular practice would suggest that it is <u>not</u> a well-functioning competitive market. Rather, the practice (unlike other forms of price discrimination which may exist in, and even support, a

[103] OFT, *supra* note 9, at paragraph 8.12.

[104] *Id*, at paragraph 5.25.

[105] For instance, in Dobson and Waterson's (2006) analysis, *supra* note 99, best-response symmetry can be readily seen if respective monopoly positions held by the competing chains are interpreted as being in a common (larger) local market but with demands being completely independent, so that best-response functions under local pricing are respectively horizontal/vertical (intersecting at the local monopoly price). For an oligopoly market where competing chains are viewed as imperfect substitutes by consumers, then reaction functions are upward sloping (and intersect at less than the relevant local monopoly price). However, the intersection point may be higher or lower in the former compared to the latter depending on the extent of consumers' willingness to pay in these respective local markets. For example, if consumer incomes are very low in a monopoly market, then prices may be below those in an oligopoly market under local pricing (i.e. then the former represents the "weak market" while the latter the "strong market"). More normally, though, we might expect a monopoly market (where chains face independent demands) to represent the "strong market" and the more competitive market (where chains are imperfect substitutes) as the "weak market".

[106] For example, with distinctly convex demand functions, economic analysis shows that it is possible that third-degree price discrimination could be social welfare enhancing in the sense of increasing total industry output even in monopoly – see Hal R. Varian, "Price Discrimination and Social Welfare, *American Economic Review*, Vol. 75, 870-875, 1985; and Marius Schwartz, "Third-Degree Price Discrimination and Total Output: Generalizing a Welfare Result", *American Economic Review*, 80 (5), 1259-1262. However, it is normally the case that price discrimination practices that raise profits do so at the expense of consumer welfare, which may matter considerably if the welfare standard adopted by a competition authority relates to consumer welfare rather than total economic welfare.

[107] Again, see Dobson and Waterson (2006), *supra* note 99.

well-functioning competitive market[108]) would not arise in the absence of local market power (since if all local markets were truly competitive then prices across all markets would be set in a manner that truly reflected costs – and not differences in local competition levels).[109]

A significant exception justifying discriminatory local pricing in this context would be where price discrimination allows for a significant increase in the overall market size.[110] For instance, this would apply if price discrimination allowed retailers to venture into new areas where consumer willingness to pay was so low that unless prices for those areas were set low then these markets would go unserved (i.e. in "very weak" markets), while at the same time not making consumers in existing ("strong") markets worse off with higher prices (and possibly even lowering prices when the sector expansion allows for fixed costs to be spread further). This arguably may have some application in rationalising and justifying why pharmaceutical companies, with large upfront R&D costs to cover, may apply very different price structures from one (rich) country to another (poor) country for the same drug.[111] However, this argument would not appear relevant to the context of UK grocery retailing, where effectively the whole population is already served and local markets appear able to be served by local pricing and national pricing retailers alike.

[108] For instance, second-degree price discrimination where discounts are given with larger unit sizes may support a well-functioning market by increasing the overall volume of sales and keep average costs down where increasing returns to scale are available (e.g. when high fixed costs are present).

[109] In contrast, for promotion-led (but not predatory-led) below-cost selling, it is not the presence of market power *per se* that lends itself to the practice and indicates that it is not a well-functioning market. Rather it is another market failure in the form of consumers' lack of complete information on all prices that encourages retailers to operate with low (even negative) margins on items where prices are known (i.e. KVIs) which strongly influence which store they will visit. See Christopher Bliss, "A Theory of Retail Pricing", *Journal of Industrial Economics*, Vol. 36, pp. 375-391, 1988; and P.P. Walsh and C. Whelan, "Loss leading and Price Intervention in Multiproduct Retailing: Welfare Outcomes in a Second-Best World", *International Review of Law and Economics*, Vol. 19 (3), pp. 333-347, 1999.

[110] A further exception supporting the need for price discrimination could arise in a situation where firms could not cover fixed costs if all local markets were intensely competitive. In this case, efficient Ramsey pricing may require differential prices being applied across local markets that were significantly different in size and consumer willingness to pay. This is an argument that may have some application to utility and telecommunications sectors (given the very high proportion of fixed costs), but does not appear reasonable in sectors like retailing where operating costs are highly variable and where there will always be some degree of differentiation in the market (by location, retail brand name, product range/assortment, etc) to the extent that the sector will at best likely be monopolistically competitive rather than perfectly competitive, and so normally allow for fixed costs to be covered for the industry as a whole.

[111] For informal examples, see Harford, supra note 29, at pages 54-57; and Armstrong, *supra* note 91, at page 9. For formal analysis, see S. Layson, "Market Opening under Third-Degree Price Discrimination in Oligopoly", *Journal of Industrial Economics*, Vol. 42 (3), pp. 335-340, 1994.

4.3. Impact on Dynamic Outcomes

In addition to the consideration of the net balance of effects across separate markets/segments for given states of demand and competition, economic analysis has also considered the impact of pricing policy on market dynamics in two important regards: first, whether the pricing behaviour might facilitate collusion or a general uplift in prices; and second, whether it might impact on market structure (e.g. concentrating markets by inducing exit of rivals or deterring new entry) thereby affecting future competition in the sector.

4.3.1. Price Transparency and Likelihood of Collusion

On the first aspect, a concern expressed about uniform pricing is that it may make collusion easier due to increased price transparency as this allows rivals to establish more easily key focal prices on which to collude and also allows more straightforward monitoring of other's prices (as the price in one store would be the same across the entire chain so any deviation from the collusive level would be quickly spotted). It has been argued that this may deter a firm undercutting its rivals as this would have to entail a general price cut (i.e. across all stores) and this would trigger a rapid response from rivals, bringing all prices down in the market (so not much short-term gain, and a substantial long-term loss).[112]

However, greater price transparency is a double-edged sword. While in principle it might assist easier co-ordination amongst rivals, it may also make it easier for consumers to become more informed about competing retail offers and so help evaluate more clearly which retailer offers the best value according to their needs (e.g. by drawing on the greater reliability of price comparison websites like www.tesco.com/pricecheck, www.trollydolly.co.uk, and www.mysupermarket.co.uk). With greater general price awareness amongst consumers, then rivals may be induced to compete more intensely for their custom. This may in turn mean that the rivals focus on price as the key means of competing rather than on non-elements that serve

[112] Equally, though, if price discrimination results in more intense competition than uniform pricing under non-cooperative behaviour then game-theoretic analysis would suggest that collusion over the former may be more sustainable as the rewards are higher and punishment from deviation would be more severe. See, for example, Gehrig and Stenbacka, *supra* note 97, at pages 152-4. For some formal

to differentiate their offers from each other. The result may be a narrowing of prices across similarly positioned retailers, as retailers seek to avoid having loyal (relatively price blind) customers turning into promiscuous cherry-picking (i.e. price aware bargain hunting) customers.

Indeed, there may be something of a natural experiment going on presently in the one-stop shop sector in the UK following the voluntary move to uniform pricing by all the main players. Here, it was noticeable that following Morrison's takeover of Safeway, and Tesco and Sainsbury joining Morrison and Asda in operating with essentially national price lists, that prices have narrowed quite markedly across the Big 4 retailers.[113] Also, there is some evidence that these moves coincided with significant price deflation in the sector.[114] While these findings do not rule out future price rises if market actions become more co-ordinated over time, they do suggest that the move to uniform pricing may have spurred (or at least be linked to) increased competition in the short term and that lower prices may possibly be carried forward. Moreover, this suggests that any move to drop national pricing and return to widespread price flexing might harm consumer welfare if it were to reduce the focus on direct head-to-head price competition presently taking place at the national level.

4.3.2. Predatory Effects

On the second aspect, the potential impact on market structure, a major concern with price discrimination is that it may act in a predatory manner, e.g. whereby a firm with substantial market power, spread across a number of local markets, may be able to use selective price cuts to target and undermine smaller local firms in particular local markets, driving them out of these markets while at the same time serving as a deterrent to potential new entry. The advantage of using predatory behaviour through

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analysis along related lines, see Barnali Gupta and Guhan Venkatu, "Tacit Collusion in a Spatial Model with Delivered Pricing", *Journal of Economics*, Vol. 76 (1), pp. 49-64, 2002.

[113] This is, for example, evident from inspection of the weekly price surveys over recent years conducted by *The Grocer* (e.g. *The Grocer 33* and *The Grocer 100* indices) where a narrowing of prices is reported across the "Big 4" one stop-shop retailers (i.e. Tesco, Asda, Sainsbury and Morrison), but a marked price gap continues to exist between these retailers and mid-sized format retailers (e.g. Somerfield and Waitrose).

[114] For instance, see OFT *supra* note 9 (at Figure 4.6 where real food prices are shown to have steeply declined by more than 8% from January 2002 through to October 2005); and Ratula Chakraborty, Paul W. Dobson and Jonathan S. Seaton, "Pennies from Heaven: Falling Prices with Rising Retail Concentration", presented to the WZB/Humboldt University sponsored Research Workshop on Advances in the Empirical Analysis of Retailing, Berlin, 9 September 2006.

such price discrimination is that it only adversely affects short-term profits in the targeted markets, as the other local markets will be unaffected (and indeed may somewhat compensate the dominant firm if this allows for higher prices in these other markets than would otherwise be the case if it were instead to operate a uniform pricing policy).[115] The same logic applies to a dominant broad-based retailer (e.g. a one-stop shop operator) using selective price cuts to target specialist stores (e.g. butchers, bakers, green grocers, delicatessens, etc.) in different market niches.

Thus, for example, the combination of local price flexing with targeted below-cost selling could form a powerful discriminatory cocktail focused on undermining small local or specialist retailers. However, in practice, this is not likely to be used to kill the opposition quickly since if a below-cost selling campaign became too extensive then it might trigger a more general price war in the market (i.e. damaging to big and small retailers alike). Instead, the death of small or specialist retailers is more likely to be a slow, drawn out affair rather than a quick exit – i.e. the equivalent of gradual arsenic poisoning rather than a shooting with a dominant player running the risk of being caught holding a smoking gun by the competition authorities. In this way, dominant retailers can enhance their reputation with consumers (to gain more trust) and extend their market share, while causing smaller/specialist players unable to match the low prices to lose scale and thus be placed at an increasing cost disadvantage, eventually driving them out of the market while all the time ensuring that the dominant retailers avoid damaging their overall profit margins. With reduced competition, the remaining retailers may then be able to raise prices.[116]

This is the risk with allowing major players possessing significant market power to use *persistent* below-cost selling, i.e. where certain goods are sold with negative net

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[115] For an extensive discussion of the different possibilities for price discrimination impacting market structure, see Robert Spector, "The strategic uses of price discrimination", in *Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005. On formal economic analysis, see Armstrong, *supra* note 69; and Iñaki Aguirre, "The Most-Favoured-Customer Pricing Policy and Competitive Advantage", *Bulletin of Economic Research*, Vol. 52 (3), pp. 215-23, 2000. On relevant legal aspects and interpretations under EU law, see Damien Geradin and Nicolas Petit, "Price discrimination under EC competition law", in *Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005. On relevant economic tests of competitive harm, see RBB Economics, *Selective Price Cuts and Fidelity Rebates*, OFT Economic Paper Series, Office of Fair Trading, OFT804, 2005.

[116] If this is an ongoing process over many local markets, then predatory behaving retailers advancing low price reputations may take their time to exploit fully any reduced levels of competition – a

retail margins over a prolonged period (e.g. covering months or years) either by intention or through being caught in a competitive trap (with no player wanting to be seen by consumers as the first to raise prices). The practice can distort retail competition to the detriment of consumers, but also adversely affect producer competition (e.g. when it distorts category "pricing architectures", potentially impacting on production plans and investment, and harms product or brand reputation).[117]

4.3.3. Entry Deterrence

Predatory effects arising from discriminatory practices may not only decrease the number of existing players. The same effects may also serve to deter entry. Thus, in the knowledge that powerful incumbents could use a targeted combination of below-cost selling and price flexing, a potential entrant may be deterred from entering a local market if it believed that it would struggle to survive by obtaining sufficient customers paying sufficiently high prices to cover both its (sunk) entry costs and ongoing operating costs.[118]

Moreover, the precision with which powerful incumbent retailers could target a new entrant may not be just down to the ability to price aggressively in the local market as a whole (which may temporarily benefit consumers with lower prices before being raised when the threat of entry recedes). Incumbency advantages can also arise from the detailed knowledge that existing players have about local customers. If existing players can then target those customers who would likely defect to a new entrant (e.g. while the entrant was in the process of entering the market) then entry may be deterred more effectively and cheaply (since price reductions need only be made available to a limited pool of local customers, rather than all of them – so any temporary price benefit would only apply to this pool).

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situation that Albert Foer aptly terms "slow motion predatory pricing". See Albert A. Foer, "Mr Magoo Visits Wal-Mart: Finding the Right Lens for Antitrust", AAI Working Paper, November 2006.

[117] The term "price architecture" relates to the hierarchy of prices and relative price differentials between products within the same product category based on cost and perceived quality differences. For example, it is possible that brand and product image may be undermined by greatly fluctuating prices and price gaps being artificially distorted by retailers' below-cost pricing behaviour and focused competition on KVI's. See Dobson (2002), *supra* note 67, for detailed consideration of the range of possible economic effects of below-cost selling on both retail and supplier markets.

As an illustration of this ability to use local information as an incumbency advantage to fight new entry, consider the following statement by Tesco's marketing director, Tim Mason, on a "side-benefit" of Clubcard:[119]

> When a competitor opened up against one of our stores, we were able to see those customers that stopped shopping and we able to do something about that. We knew the names and addresses of the couple of thousand people whose behaviour changed. If you were being aggressive about defending your store, previously you would have taken out advertisements in the local paper which said that you could get £2 off every £20 that you spend and £5 off every £50 that you spend, come on down! All those newspapers went through the doors of people who hadn't changed their behaviour at all and the costs were so exorbitant that actually you couldn't really afford to defend yourself very effectively. This completely changed the whole way in which we were able to defend ourselves from people opening new space against us.

In other words, the added benefit of the information advantage offered by operating a loyalty card scheme combined with price discrimination through very precise customer targeting, rather than a more blunt and costly local price flexing policy, is that it could offer a very effective means of deterring entry without significantly harming even short-run profits. Such concerns may outweigh the benefits of loyalty schemes where they otherwise might trigger more intense competition (especially amongst symmetrically positioned firms) as they seek to compete intensely to secure consumer loyalty in the first place.[120]

4.3.4. Building Customer Loyalty

As well as the consideration of the discriminatory effects of micro-marketing, account also needs to be taken of how the practices may affect competition more generally through consumers' perceptions of the degree of substitutability (or equivalently the extent of differentiation) between competing retail offers. The more dependent and reliant consumers become on a particular retailer, then the greater the prospect of the retailer being able to exploit that position to its advantage by raising prices. Thus

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[118] For formal analysis on entry deterrence through price discrimination, see Mark Armstrong and John Vickers "Price Discrimination, Competition and Regulation", *Journal of Industrial Economics*, Vol. 41 (4), pp. 335-360, 1993. In addition, see Armstrong, *supra* note 88.
[119] Quoted in Humby and Hunt (2003), *supra* note 11, at page 33.

marketing which builds up customer loyalty may eventually allow the retailer to set higher prices.

However, building up customer loyalty does not come without its costs. With all retailers seeking the same outcome then there may be intense competition to build up loyal customer bases.[121] Accordingly, as long as there are customers that are not geographically, financially or psychologically locked into using a particular retailer, then there could be intense competition for their loyal custom, which may benefit all customers. Nevertheless, the problems may arise for consumers if and when all customers are eventually locked in, since at that point competition can be expected to subside, even evaporate entirely. Thus, from a consumer welfare perspective, it helps if there are consumers that are not locked in and they continue to shop around and be promiscuous in their shopping behaviour by bargain hunting across different stores. They not only serve themselves well, but may also serve the retailer's other (locked-in) customers, if the retailer cannot effectively discriminate between the different consumer types.[122]

4.3.5 Retail Variety

Finally, it should be borne in mind that retail variety, through a different mix of retail propositions, may not only be important in providing heterogeneous consumers with an appropriately wide choice to cater to their specific shopping needs. Retail variety itself may act as a spur to competition and help ensure that markets remain competitive and innovative.[123] Accordingly, preserving the market conditions that

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[120] For details on the potentially pro-competitive effects of loyalty schemes where rivals can target each other's customers with personalised low-price deals, see Mark Armstrong (2006), *supra* note 88.

[121] For example, in the context of dynamic price discrimination in oligopoly with competition before and after consumer lock in, again see Mark Armstrong (2006), *supra* note 88. Also, see Yongmin Chen, "Oligopoly price discrimination by purchase history", in *Pros and Cons of Price Discrimination*, Swedish Competition Authority, 2005.

[122] However, even here retailers may find ways to discriminate between different consumer groups over time, based on their purchasing history. For examples and discussion of the impact on competition, see Drew Fudenberg and J. Miguel Villas-Boas, "Behavior-based price discrimination and customer recognition", in T. Hendershott (ed.) *Handbook on Economics and Information Systems*, Elsevier: Amsterdam, forthcoming.

[123] This is particularly evident in respect of how certain product and service innovations have arisen in the past and then spread across the sector. For instance, the extension of own-label goods into budget and premium ranges was largely driven by the presence of particular competitors offering different retail propositions from the existing norm. The main incumbent supermarket groups, for example,

support variety, and allow for new entry with innovative propositions, may take on some considerable economic importance in ensuring the long-term health of the sector and make sure that consumers' needs are best served in both the short run and long run.

Summary

To recap, for given market configurations, economic theory demonstrates that different forms of price discrimination compared to non-discrimination can make consumers as a whole better off in some instances, and worse off in others. Much depends on the precise circumstances and form of discrimination being applied.

Specific consideration of price flexing, and associated forms of geographic discrimination giving rise to differences in value-equivalent prices across separate local markets, shows that this practice can harm overall consumer welfare. This may be expected to arise where higher weighted average prices result from higher prices in more concentrated local markets (as a result of exploiting greater local market power) not being off-set by equivalent (and thus potentially quite significant) lower prices in more competitive local markets. Even so, it is a balance of effects (some static, some dynamic) that needs to be considered and suggests the need for careful consideration of the overall market circumstances to determine net outcomes.

Yet, unlike perhaps other forms of discrimination that can arise in very competitive circumstances, the presence of significant price flexing is indicative of a lack of effective competition – where prices are set with respect to consumer willingness to pay and the relative strength/weakness of local competition, rather than according to cost levels. Moreover, any immediate detriment to consumers is only likely to grow worse over time if price flexing is used to exploit consumers with high prices in areas where they face limited store choice, while driving out (and preventing entry of) smaller/specialist rivals with low prices in more competitive areas (especially if this

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launched budget own-label ranges in the 1990s as fighting lines in response to the arrival of the hard discounters from continental Europe (like Aldi, Lidl and Netto). Similarly, the more recent launch of premium own-label ranges by the main supermarket groups appears to have been a response to the challenge offered by premium positioned retailers, notably M&S. In the absence of such competition, the present multi-tier own label offer may not have materialised, or at least been delayed.

practice can be used in conjunction with below cost selling on KVIs and individual consumer targeting through database marketing).

Accordingly, the ability of powerful retailers to apply a combination of discriminatory practices should give cause for concern that overall consumer welfare could suffer in both the short and long term. Yet, the ability to undertake this behaviour in a detrimental way to consumers ultimately stems from the unevenness of competition across local markets; where not all consumers benefit from the same level of competitive intensity. In this situation, the absence of non-cost-justified discrimination may be preferable to its presence, but it would still not leave consumers as well off as they could expect if <u>all</u> local markets were to display truly effective competition. Thus, collusion concerns aside, while a move to national pricing might offer consumers a better overall deal than one where retailers use local pricing, that deal would be better still if competition were intense across all rather than some or even most local markets.[124]

Similarly, other discrimination and segmentation policies that may harm consumer welfare stem from retailers exploiting consumers' lack of market knowledge (e.g. on the full range of prices and quality of products on offer) and inability/unwillingness to shop-around for bargains. To the extent that these policies facilitate retailers in competing aggressively to build up loyal customer bases at each other's expense, they may intensify competition (at least in the short term). However, where such practices concentrate on exploiting consumers' information deficit and store loyalty, through extracting consumer surplus and avoiding competition, then they will more likely have adverse effects on both competitive and dynamic outcomes.

[124] This is because any national price set by a retailer would be based on its average market power across local markets – e.g. being higher the more local monopoly markets it controlled, and the lower the more perfectly competitive local markets it operated in. Similarly, with local pricing, the average of local prices would depend on the composition of local markets in which the retailer operated - be being higher the more local monopoly markets it controlled, and the lower the more perfectly competitive local markets it operated in.

5. POLICY CONSIDERATIONS

This concluding section of the report looks at the relevant policy considerations in relation to the present CC inquiry concerning the nature of competition presently taking place in local retail markets, and the sector more broadly. The section begins by examining the relevant welfare benchmarks and comparisons by which retail practices may be assessed and judged. It then considers the types of evidence that would be helpful in assessing the nature of competitive effects of discriminatory practices and the extent to which consumers may be harmed. The section then moves on to consider possible remedies to any identified adverse competition effects resulting from micro-marketing practices, discussing the criteria on which assessment might be based and then applying this to consideration of three different classes of potential remedies: prohibitions, increasing consumer information, and reducing local market power.

5.1. Relevant Welfare Benchmarks and Comparisons

As shown in the previous section, the net economic effects of discriminatory practices are not clear *a priori*. The direction and magnitude of effects can only be determined by examining the practices in their market context. Typically a balance of effects that will need to be taken into account since discriminatory effects can be potentially different for different consumer groups (e.g. favouring one group, but harming another group) and different timeframes (e.g. predatory behaviour offering short-term benefits from low prices but long-term detriment from reduced choice and eventually higher prices). Discriminatory practices also have the ability to intensify competition at a general level in certain circumstances, while dampening competition in other circumstances. Even so, as we have seen in the previous section, economic theory does provide some useful guidance on these matters. In particular, it gives cause for concern that certain practices currently employed in UK grocery retailing have the potential to distort, restrict and/or prevent competition.

Moreover, where there are adverse effects identified, it is conceivable that discriminatory practices may be both a *symptom* and a *cause* of ineffective competition. For example, this might apply to both persistent below cost selling and local price flexing. With the former practice, the incentive to focus on below-cost selling on a limited number of KVIs arises because consumer price awareness and consciousness is limited. The more that the major retailers focus on promoting these items then the more likely it is that focused consumer attention is on the prices of these products in making choices over where to shop and what to buy. Thus a cycle of unbalanced consumer information and awareness might be built up, which then affords the possibility of persistent below-cost selling of certain KVIs serving a predatory purpose (whether by design or simply by outcome). Whereas, with the latter practice, the incentive to employ price flexing arises because of uneven local competition, where a weakness or absence of competition in some local markets allows for higher prices compared to prices set in other local markets where competition is more intense. Apart from exploiting local competition differences (to capture higher levels of consumer surplus), the practice may also affect overall competition through offering a means by which powerful retailers can simultaneously pursue soft and aggressive forms of competition applied in different local markets according to how they wish to compete against particular rivals.

Furthermore, this ability to influence as well as exploit the nature of local competition may be increased when discriminatory practices can be used in tandem, i.e. as a "discriminatory cocktail", e.g. combining below cost selling with local price flexing and individual consumer targeting though database marketing. Such a combination could simultaneously allow for selective targeting to undermine or eliminate smaller/specialist rivals while extracting consumer surplus in locations where competition is weak or absent (thereby ensuring that short-term profits are not unduly damaged and offering the prospect of higher long-term profits when competition is reduced).

Accordingly, with these strategic and dynamic effects at play, in assessing economic effects it may be inappropriate simply to compare practices and counterfactuals for given market configurations and existing behaviour, since the practices may themselves have influenced and may be expected to continue to influence market outcomes. This suggests that any possible damage already done to markets needs to be taken into account and how this might relate to any underlying reasons for ineffective competition arising in the first instance and then being possibly exaggerated by the practices (e.g. in extending the competitive advantages of major players, allowing for strategic barriers to entry/expansion to arise, distorting consumer behaviour, and reducing store/fascia choice, variety and amenity).

In regard to persistent below-cost selling, the CC in 2000 focused on two ways in which the practice distorts competition in the retail supply of groceries: firstly, the practice, with its emphasis on discounting KVIs, indicated that "a majority of [grocery] products are not fully exposed to competitive pressure"[125]; and secondly, the practice damages small/specialist stores "by channelling competition so intensively that losses are incurred that have to made up in higher prices charged on other products"[126] with the consequence that it may "contribute to the closure of such stores, thereby reducing consumer choice and amenity"[127].

By implication, the CC took the view that in the absence of persistent below cost selling a greater range of products would be exposed to competitive pressure. However, simply ending the practice may not achieve this outcome (or at least may do so only over a significant period of time) given that consumer behaviour has (presumably) already been affected by the practice. This suggests that comparing the existing situation with the counterfactual of the practice no longer being present in the context of the existing market configuration may not be the appropriate or at least not the only standard on which to assess the practice. For example, it would be useful to compare the outcomes arising from the practice in its present context with those that could be expected to arise in a situation where competition was truly effective (where using this particular practice would no longer appear to make economic sense). In other words, the benchmark should be with regard to outcomes as they currently stand as compared to those that could be expected when effective competition prevails widely.

This in turn may give cause for considering not just remedies that directly limit the practice but also about adjusting retailers' underlying incentives for using the practice,

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[125] CC (2000), *supra* note 8, paragraph 2.387.
[126] *Id*, paragraph 2.387.
[127] *Id*, paragraph 2.393.

e.g. by suitably influencing consumer behaviour or altering market structure to make local markets more competitive. In this way, powerful retailers may be prevented or deterred from using this practice or indeed switching to using another form predatory behaviour to elicit the same effect. Indeed, one may go even further by arguing that the starting point should be how to change incentives to avoid the need to directly limit practices (since clever firms may be able to find a way around restrictions or prohibitions unless they are very well designed).

With price flexing, the CC in 2000 took the view that this practice distorted competition and was against the public interest because consumers "tend to pay more at stores that do not face particular competitors than they would if those competitors were present in the area".[128] One of the main parties to the current CC inquiry contests this finding arguing that it was "flawed" being based on "the wrong counterfactual in that it fails to make the relevant comparison, i.e. between uniform and flexed prices for a given configuration of stores" and that "the CC did not establish that abolishing local price flexing (and requiring uniformity) would lead to lower prices overall".[129] Here, it can be presumed that the CC was making its judgement based on what consumers could expect to pay if effective competition prevailed across <u>all</u> local markets rather than just some (or even most). On the same basis as the discussion above, this is an entirely reasonable comparison to make as it points to the extent to which local market power through limited consumer choice can be abused to raise prices. Specifically, it is only right and proper that the counterfactual in a market investigation should involve some analysis of what effective competition looks like.

Equally, though, it would be appropriate to compare outcomes under local pricing with the counterfactual of national pricing for the presence market configuration. Here, economic theory (as discussed in the previous section) would suggest that it is possible that the prevailing oligopolistic market conditions in UK grocery retailing sector (and in contrast to the claims made in some main party submissions[130]) may

[128] *Id*, paragraph 1.6(b).
[129] Asda, *Overview Submission – Groceries Inquiry*, Non-confidential version, 10 August 2006.
[130] For example, the non-confidential submissions by Asda and Tesco suggest that the practice is pro-competitive as it can allow retailers to meet local competition. However, while it may be pro-competitive in certain local markets when it encourages the retailer to meet local competition by setting

mean that price flexing by the major chains might lead to higher weighted average prices compared to uniform pricing. If this were considered to be the case (perhaps based on evidence relating to changes in retailers' pricing strategies over the last few years), then it would suggest that encouraging a (non-transitory) move to national pricing would be a useful policy measure. However, this on its own would not likely tackle the underlying cause of high prices, which would be down to the continued presence of local market power in certain areas. Specifically, for the present configuration of stores, weighted average prices might be judged likely to be lower under national pricing compared to local pricing, but they could still be significantly higher than they would be in the complete absence of local market power and effective competition prevailing across all local markets (since weighted average prices under both regimes would increase with the greater the number of local markets exhibiting ineffective competition and restricted choice).

Disentangling the two considerations – i.e. comparing outcomes in the present context and comparing outcomes with a situation of truly effective competition – would help in considering the appropriateness of remedies that sought to change retailers' behaviour (e.g. by directly curbing the practice of price flexing) but also about adjusting retailers' underlying incentives for using the practice (e.g. by suitably altering market structure to make local markets more competitive). In this context, a critical issue will be identifying the source of local market power. Is it due to limitations on consumer choice in respect of the ability to access different stores or access different retailers? The answer may lie with applying a "store test" and a "fascia test" in local markets to gauge the extent of effective local choice in both respects. This may then suggest whether there is a need for remedies that specifically address the reason for a lack of local competition. In practice, it may well be found that both aspects are relevant – i.e. insufficient store and fascia choice – but the balance may differ from area to area depending on the extent of retailer consolidation in certain parts of the country, the number of stores/retailers that could feasibly be

low prices, this argument ignores what happens in local markets where competition is weak or absent and where price flexing allows retailers to exploit their local market power. As discussed in the previous section, economic theory suggests that the balance of effects could well mean that price flexing allows for higher overall weighted average prices, and thus potentially serves to the collective detriment of consumers.

supported for a given local market size and character, and the effectiveness of impediments to entry (e.g. local planning restrictions).

The critical point to take away from this discussion is that if market structure and competitive conditions could be modified in a way that reduces local market power and ensures that effective competition and choice is available in most if not all local markets, then the incentive to practice price flexing and other forms of geographic price discrimination in a manner detrimental to consumers overall would be significantly reduced. In turn, removing the incentive or ability to act in harmful way means that there should be less need for regulation of retailing behaviour on operational issues relating to marketing policy.

5.2. Gathering Evidence on Practices

The present CC inquiry offers an important opportunity to gather and analyse empirical evidence on retailer practices that may be distorting or restricting competition. This sub-section considers the nature of the evidence that might be usefully sought to assist in determining the net economic effects of the different practices that arise under the broad umbrella of micro-marketing. Evidence relating to three sets of practices are considered in turn: (1) persistent below cost selling; (2) price flexing and other forms of geographic discrimination; and (3) consumer segmentation and targeting practices.

5.2.1. Evidence on Persistent Below Cost Selling

It is clear from the OFT's report detailing its decision to make a reference to the CC for the current inquiry that below cost selling is still endemic amongst the major chains.[131] On the face of it, little appears to have changed in the six years since the last CC market inquiry. Yet, the OFT's analysis does not distinguish between short-term and persistent below cost selling cases, so it is not clear how important are the latter type of cases. In the circumstances, a very detailed second look at persistent below cost selling appears warranted.

However, unlike the previous CC inquiry, any investigation of the practice should bear in mind that it not only has the potential to distort *retail* competition (by distorting consumption patterns and serving a predatory purpose by eliminating or further weakening smaller retailers). The practice also has the potential to distort *producer* competition. Specifically, the practice can adversely affect sales levels of non-KVI producers (so weakening their competitive position) while at the same time leading to greater bargaining pressure on KVI producers (making it difficult to cover costs and make adequate returns), as major retailers seek to obtain lower KVI prices to enhance their competitive advantage over other retailers (including intensifying the predatory effect). Either way, producers may find themselves squeezed and the effects are most likely to impact on small producers. Consumer detriment may then arise not just in distorted pricing architectures and restricted choice (if small producers are forced to exit the market) but also from the possibility of reduced product quality – as producers are forced to "cut corners" in order to stay in business.[132]

Detailed evidence on five aspects would appear especially useful:

(i) the extent of the practice across different retailers, different product categories, and different quality types (e.g. value brands through to premium quality brands)

(ii) whether the products sold below cost on a persistent basis constitute a reasonable "basket" of goods, i.e. a set of goods which might reasonably weigh in the minds of the consumer in determining which store to visit (which seems possible in the wake of the OFT's evidence on how widespread the practice appears across different product categories),

(iii) whether (as a follow-up to the CC's analysis in 2000) the persistently sold-below-cost goods (and particular pack sizes/weights) are proportionately more important to smaller retailers (e.g. convenience stores) – to indicate possible predatory intent or effect,

[131] OFT, *supra* note 9 (paragraphs 5.9-5.18).

[132] See Dobson (2002), *supra* note 67. Also, on the potential of buyer power to distort producer competition and affect product choice and quality, see Paul Dobson, "Retailer Buyer Power in European Markets: Lessons from Grocery Supply", Loughborough University Business School Research Series, No. 2002: 1, June 2002.

(iv) whether there is evidence that the practice has been used in conjunction with localised or targeted promotions – e.g. deliberate targeted promotions (such as through home-delivered leaflets and vouchers or local advertisements) relating to these goods in specific locations where small retailers operate but less so in locations where big retailers operate – again indicative of predatory intent.

(v) the extent to which persistent below cost selling may have harmed category sales (e.g. arising from distorted price architectures) and/or category product quality, choice and innovation.

5.2.2. Evidence on Price Flexing and Geographic Discrimination

As discussed in section 3.3 above, it is clear from the CC's 2003 inquiry into the contemplated Safeway mergers[133] and the recent OFT report[134] that the major grocery chains have changed their tactics regarding price flexing. Rather than adjusting prices according to local competitive conditions, some retailers (notably Tesco and Sainsbury) now operate discriminatory pricing based on the retail format (with higher prices for small format stores and lower prices for large format stores). There are, nevertheless, various remnants of local price flexing, e.g. the use of local vouchers mentioned in the OFT report[135]. Yet, broad concerns remain about local flexing and geographic discrimination across different local markets, for at least five reasons:

- As the CC and OFT have previously commented, there is no reason why the big chains may not resort to price flexing again in the future (e.g. when the regulatory spotlight is off them). Thus it is important to consider the level of genuine and irreversible commitment that retailers may have towards national pricing (and correspondingly how easy it would be opportunistically to switch to local pricing if this were viewed as likely to increase profits).
- This kind of discriminatory practice can be readily applied to differential on-line (i.e. Internet) and off-line (i.e. store-based) prices for retailers with "bricks-and-clicks" operations, as well as between different store sizes and store locations.
- Also, it is evident that price flexing is still going on, but not necessarily on food. A prime example is supermarkets' petrol retailing which involves

[133] CC (2003), *supra* note 6.
[134] OFT (2006), *supra* note 9.
[135] *Id*, paragraphs 5.19-5.20.

supermarkets setting local prices based on the intensity of local competition conditions (with prices appearing to be influenced by the proximity of Asda or another petrol discounter – see www.petrolprices.com)

- Even if retailers do not blatantly tailor local prices, then they have other means available to adjusting the local retail offer (e.g. by adjusting local advertising, in-store promotions, product range, category depth, and quality emphasis).
- Retailers can also adjust their service levels and investment decisions (rather than merely tactical marketing decisions) on a local basis (e.g. regarding decisions over store format, size, specific location and even fascia, as well as amenities and service levels to suit local competitive conditions).

This would suggest that in regard to local flexing, the CC should perhaps consider looking more generally at the micro-marketing and local investment behaviour of the main chains. Specifically, it would be important to see whether there is any evidence of the big chains not offering consumers the same levels of service, quality, amenity, choice, and promotions in certain locations compared to other locations (i.e. denying consumers the same products, depth of ranges, special promotions, and store amenities beyond what can be justified by local costs and local market size differences). This is, after all, directly analogous behaviour to local price flexing, which the leading chains now claim to have eschewed.

More specifically it may be possible to obtain evidence in an objective way through mystery shopper inspections and consumer surveys to see whether there are discernible differences in how the major chains operate across different localities in respect of the “PQRS” (i.e. “price, quality, range and service”) dimensions that they would normally be expected to compete on. Specifically, it would be useful to know in areas where there is less local competition (either in respect of store numbers or competing fascias) compared to other areas whether there is any evidence in respect of the following aspects of the retail offer:

1. <u>Prices</u>
    - Higher prices for identical products
    - Fewer special offers
    - Fewer coupons/vouchers distributed locally

2. Quality
    - Less fresh produce
    - More congested aisles
    - Poor signage/labelling
    - Higher frequency of stock outs
3. Range
    - More restricted product range by breadth and/or depth
    - Emphasis on higher priced products (in absolute/or and unit terms)
    - Fewer value/budget lines
    - Limited in-store promotions
    - Less choice of special products (gift/luxury items, delicacies, etc)
    - Reduced non-food offering (personal care, electrical goods, books, newspaper, magazines, etc)
4. Services
    - Fewer facilities/amenities (toilets, petrol station, restaurant/café, ATMs, pharmacy, lottery terminals, crèche, dry cleaner)
    - Fewer service counters (e.g. fresh fish, fresh meat, delicatessen, bakery, hot/cold take-away food)
    - Less convenient car parking
    - Shorter opening hours
    - Less staff for assistance/bag packing
    - Fewer checkouts open/longer queues
    - Absence of self-scanning in-store
    - Reduced or deferred store refurbishment expenditure
    - Less clean/tidy/well-decorated store
    - Smaller store size
    - No recent or planned store expansion (when feasible)

Evidence of this kind would indicate that retailers are continuing to differentiate their offers on a local basis and this may be related to the unevenness of local competition across local markets. However, consideration should also be given as to the extent to which any variation is cost-justified or conditioned on the nature of the local community (e.g. incomes and demographics) served by the relevant stores.

5.2.3. Consumer Segmentation and Targeting Practices

While persistent below cost selling and local flexing are likely to form the main interests of the CC in its present inquiry, it would be useful to see whether there is evidence of other practices that exacerbate discriminatory effects or distort competition in other ways.

From the discussion in section 2, segmentation and targeting practices that draw on database marketing, particularly when linked to loyalty card schemes, are becoming more widespread. As noted in section 4, they can give rise to anti-competitive concerns when they are designed to encourage and then exploit consumer loyalty, while at the same time offering a very effective and efficient means to behave in a predatory manner. Such database marketing and individual-targeting practices are worthy of further consideration, especially to see how they are operated in practice and whether they serve to stimulate or reduce competition.

In particular, the CC might usefully examine whether those retailers that have recently moved away from price flexing (e.g. Tesco and Sainsbury) have instead substituted this practice with individual targeting (using data drawn from loyalty card schemes like Clubcard and Nectar and/or other data sources for consumer profiling) to effect similar outcomes. In other words, is there evidence that any of the major chains use individual targeting to exploit differences in local market power at a general level (resulting in consumers paying higher average prices in areas where competition is weak)? Similarly, is there evidence for any of the major chains using such targeting methods to target disproportionately the (potential) shoppers of particular rivals (such that consumers face higher average prices if they do not live, work or otherwise shop in any of those particular rivals)?

Moreover, from a general consumer welfare perspective in terms of consumer awareness and the ability to make more informed decisions that drive healthy competition, it would also be useful to see the extent to which consumers are aware and knowledgeable about how these targeting and segmenting practices operate, how retailers and third parties use loyalty card data, and how consumer profiling and previous shopping history affects the offers that consumers receive.[136] Here, a particular concern may be that database marketing may be distorting consumers' perceptions of the real value on offer and/or may be used as means to raise rivals' costs (e.g. making it more difficult for smaller retailers to remain in markets and new entry to occur).

5.3. Need for Remedies

If the present CC inquiry were to find persistent below cost selling and price flexing to be anti-competitive and overall harmful to consumers, as the CC concluded in 2000, and perhaps other aspects of discriminatory behaviour linked with focused competition and exploiting local market power, then attention would turn to consideration of possible remedies. In its previous market inquiry, the CC examined a number of possible remedies with a view to tackling the adverse effects arising from competition being distorted and restricted by the use of persistent below cost selling and price flexing, but rejected all considered on the basis that each would be disproportionate, impractical, undesirable, and/or too expensive to monitor and enforce compliance.

The remainder of this report reconsiders the options on possible remedies, in light of developments in the sector and in light of the greater understanding offered by economic theory on the impact of these practices on competitive and dynamic outcomes. Each of the next three sub-sections considers a distinct class of remedies, with each class potentially attending to different competitive aspects arising from the practices and the market conditions in which they operate. The three classes of remedies considered cover (i) prohibitions, (ii) increasing consumer information, and (iii) reducing local market power. Each type is subjected to a broad cost-benefit assessment taking account of its *feasibility* (i.e. practicality in implementing), *suitability* (in tackling the adverse effects in a proportionate manner and without

[136] For example, survey evidence from the US shows that consumers are not very aware of how these practices operate, are not happy about individual targeting when it means preferential prices for some consumers but not for others, and are not happy about the amount of data that supermarkets hold on individuals' buying behaviour. See, Joseph Turow, Lauren Feldman, and Kimberly Meltzer, *Open to Exploitation: American Shoppers Online and Offline,* A Report from the Annenberg Public Policy Center of the University of Pennsylvania, June 2005.

giving rise to undesirable side-effects) and *acceptability* (in respect of minimising monitoring and compliance costs).

The approach taken here is not to pre-judge outcomes and the thinking to emerge from the current CC inquiry by setting out prescribed remedies that should/must be followed. Rather the approach taken is to consider the pros and cons of particular remedies with the intention that this examination might prove useful in any subsequent consideration by the CC of remedies if it were to find adverse competition effects and consumer harm arising from these practices sufficient to warrant remedies being put in place.

With this said, and before reviewing each of these classes of possible remedies, it is important to consider why taking regulatory action to remedy any adverse competition effects would be important – to ensure that effective competition prevails as widely as possible in the sector, and thereby ensure that consumers overall benefit from vigorous, fair and innovative competition. The alternative is to do nothing, as happened in 2000. But, as indicated by the OFT's basis for its reference to the CC for the current inquiry, concerns about structural and behavioural features of the sector persist in view of ongoing consolidation in the sector (including the moves by some of the major supermarket chains to enter or extend their positions in the convenience store sector).

Thus one possible line that the CC could decide to take would be again to choose not to offer any remedies even if it identified harmful discriminatory practices being used by the major retailers. In particular, it might be argued that a *laissez faire* approach would be appropriate on the basis that the scale of the problems may be small and that the firms might anyway change their behaviour as the market evolves and in the process the adverse effects would eventually disappear or at least subside. However, such reasoning appears inappropriate. Any harmful effects arising from the discriminatory practices discussed in this report are likely to persist. For instance, persistent below-cost selling still appears to be just as prevalent in the market as it was at the time of the last Competition Commission market inquiry in 2000, giving rise to continued concerns about its distortion to consumption patterns and predatory effect against small/specialist retailers. Furthermore, while some retailers may have moved away from price flexing, similar effects may well exist in other forms of geographic discrimination (through choice of product range/assortment, service levels, store amenities, store format, etc).

More generally, one might expect discriminatory practices to extend over time, as markets become more consolidated (so greater scope for exercising local market power) and techniques become more feasible (e.g. increased precision in segmenting consumers through database marketing). Indeed, as sector growth slows then competition may increasingly be framed as a win-lose situation. With broadly stable sales, the only way to increase sales significantly would be to take market share off rivals. Here the economies of scale and scope but particularly the greater buyer power of the large firms over smaller rivals would come into greater play. Specifically, the ability to exercise of enormous buyer power over supplier and extract preferential terms gives large retailers a substantial competitive advantage over smaller retailers, allowing them to price more keenly to gain market share (which in turn may feed through to yet greater buyer power, as part of the virtuous growth circle for large retailers – compared to the vicious declining circle that small retailers are placed in). Yet, rather than destroy profits through triggering a general price war, the ability to grab market share in a stealthier manner exists through increased use of below-cost selling and price flexing. This can allow large retailers to target selectively smaller rivals, while ensuring that their profits are not severely undermined in the process, so effect predatory behaviour in a more effective and less costly manner – ultimately driving up concentration levels, reducing consumer fascia choice, and giving large retailers greater scope for raising prices in the longer term.

A further reason for considering that these two practices and other forms of discriminatory behaviour will not only persist but may grow in importance is in light of the move by leading large-format grocery multiples into convenience-store retailing. Originally, the move was through the opening of a limited number of small stores in city centres. However, the pace of expansion has been accelerated by additional store openings in more general locations and through direct acquisition of convenience store groups (e.g. Tesco’s acquisition of the large T&S chain), thereby further strengthening large retailers' grip on food retailing in the UK.[137] In this situation, there is the increased possibility that the convenience stores of the major multiple retailers (operating as "fighting brands") can be used to attack directly the market share controlled by small chains and independent stores.[138] Price flexing and below-cost selling can assist this process by targeting specific local competitors, while ensuring that margins are maintained in other locations and for other products. At the same time, other convenience store outlets (especially when operated under a different fascia not linked to the main retail brand name), can be used to set higher prices and exploit conditions where local competition is weak or absent.

If anti-competitive effects are evident, then it appears appropriate that measures should be considered that specifically tackle these effects. . It is with this perspective in mind that we turn to consider three different classes of possible remedies that may separately or in conjunction potentially tackle different elements and sources of consumer harm that may arise be associated with anti-competitive discriminatory practices.

5.4. Prohibitions

This sub-section considers remedies that seek to tackle the anti-competitive effects arising from discriminatory practices by directly curbing their use either through a prohibition or a restriction on their coverage/application. The focus is on measures relating to the use of persistent below cost selling and price flexing as it is these two practices which have been previously viewed by the UK competition authorities as particularly likely to distort and restrict competition. Prohibitions/restrictions on their use have been considered previously but rejected (notably by the CC in 2000). Here, we review the arguments for and against bans/limitations on these two practices, and discuss ways in which restrictions could be devised to help remove or alleviate anti-competitive effects without introducing any significant corresponding distorting effects arising from regulation, while at the same time ensuring that regulatory costs (associated with monitoring and enforcing compliance) are minimised.

[137] For details on these developments, see OFT (2006), *supra* note 9 (at paragraphs 3.17-3.27).

5.4.1. Restricting Persistent Below Cost Selling

Persistent below-cost selling has the potential to distort and restrict competition in several respects. Perhaps most significantly, though, in the present market setting, it has the capability to act in a predatory manner – whether by design or simply as an outcome of existing distorted competition. In particular, if small or mid-size retailers are squeezed out of the market, then there will likely be no new retailers to take their place. The net result will be a reduced number of competitors, thereby reduced fascia choice for consumers, and the possibility of increased prices as a consequence of increased market concentration and the reduced ability/willingness of consumers to shop-around. In this context, it might be appropriate for the CC not immediately to rule out of consideration some form of prohibition of the practice.

In 2000, the CC decided against prohibiting the practice at a general level.[139] The CC noted that experience from other countries showed that prohibiting below cost selling could have an adverse effect on retail competition and lead to higher prices overall (rather than a rebalancing of prices between loss-making and other lines).[140] The CC also considered that a prohibition would present formidable practical difficulties (such as identifying those products persistently sold below cost and preventing retailers from forcing suppliers to provide invoices with low prices on these products while allowing them to set higher prices on other goods supplied).[141]

The CC's previous objections clearly need to be taken into account, but they are not necessarily insurmountable and they may not necessarily still hold to the same degree today (given the changes in the market over the past six years).[142]

Yet, it does appear to be the case that blanket bans in other countries have produced inflationary effects – notably in Ireland and France where recently these prohibitions have been rescinded. A recent OECD report also highlights the potential for such prohibitions to distort competition and considers their application in several

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[138] For example, see "Tesco buyout 'will kill small stores and hit communities'", *Guardian*, 20 November 2002.
[139] CC (2000), supra note 8, paragraphs 1.7-1.8.
[140] *Id*, paragraphs 2.560-2.561.
[141] *Id*, paragraph 2.562.
[142] On suggestions for tackling the practical difficulties, see Dobson (2002), *supra* note 67.

countries.[143] However, the OECD's analysis does not consider the full range of harmful effects of persistent below cost selling. For example, there is no consideration of the potential competition-damaging effects arising from distorted consumption patterns (favouring KVIs over non-KVIs), distorted category price architectures (that may affect consumers' quality perceptions within and across categories and potentially undermine category sales), and damage to brand equity and associated intellectual property (i.e. undermining investments in building up brands, which may deter new product innovation), all of which may ultimately have an adverse effect on consumer welfare.[144] Moreover, the OECD analysis fails to review and analyse all the variants of restrictions, and overall offers a highly partial and very one-sided appraisal.[145]

Crucially, just because of the inflationary experience in Ireland and France, and perhaps other countries as well, with their blanket below-cost selling bans (possibly exploited by retailers and producers alike), it does not mean that some carefully tailored prohibition might not work. Specifically, a variation on the German prohibition might work, i.e. something targeted explicitly to tackling below-cost selling which is (i) <u>persistent</u> (i.e. not about short-term loss leading promotions) and (ii) undertaken by retailers possessing <u>significant market power</u>. Despite its targeted below-cost-selling prohibition, or perhaps because of it, Germany is representative of probably the most competitive grocery retail market in Western Europe (characterised by the prevalence of hard discounters and active bargain hunting by consumers).[146]

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[143] OECD, *Resale Below Costs Laws and Regulations*, DAF/COMP(2005)43, February 2006.

[144] For more on these different effects and particularly how the combination of effects can have detrimental implications throughout different parts of the supply chain and for final consumers, see Dobson (2002), *supra* note 67.

[145] For example, while blanket or very broad prohibitions apply in some countries (e.g. as currently or previously operated in Belgium, France, Ireland, Luxembourg, Spain and Portugal), other countries have more limited prohibitions intended to prevent abuse of market power (e.g. Germany and Austria) or market dominance (e.g. Denmark and Sweden) (for details, see Dobson, *Id*). The OECD's appraisal focuses extensively on blanket bans (notably in Ireland and France), fails to acknowledge the intense price competition in some countries which operate targeted prohibitions (notably Germany), fails to consider the impact on outcomes beyond price for consumers (e.g. store choice, variety, quality, and accessibility), and fails to see the limitations of predatory foreclosure laws in tackling creeping predation cases associated with situations like persistent below-cost selling on a limited set of items (where competition is gradually rather than quickly eliminated – i.e. "slowly poisoned" rather than "shot").

[146] For details on the German legislation in this area and the positive views about its effectiveness in tackling competition problems while allowing for a very intensely competitive retail grocery market, see OECD, *supra* note 143, pages 117-121 & 201 (covering Germany's submission to the OECD Roundtable and the German delegate's contribution to the roundtable discussion).

Nevertheless, it may be possible to improve on the German prohibition with a more careful focus on the meaning and application of persistent below-cost selling and more importantly appropriately defining market power (and not simply looking at store size – e.g. as cases against Wal-Mart appear to have been based). At the same time, the lessons from France and Ireland have to be considered about how best to avoid the same problems of producers and retailers maintaining high retail prices (by using high supply prices with compensating off-invoice lump sum side payments to major retailers), and more generally increased price transparency possibly leading to parallel pricing at the retail level. Also, the monitoring and enforcing compliance costs need to be considered in evaluating the costs and benefits of such a prohibition.

Even so, in principle a well-designed targeted prohibition could work, not least as it would still allow for short-term loss-leading promotions and would still be available to those firms that did not possess significant market power. But, finding the right balance may not be easy. Retailers need freedom to price and so compete openly and effectively. This freedom should only be restricted in the most extreme cases – so that the remedy is proportionate in its effects and implications. A blanket ban would certainly not be proportionate and would likely prove inflationary (as it did in Ireland and France). A targeted ban may be considerably more suitable – only tackling the serious competition-harming cases without affecting other retail pricing behaviour. Also, administering and overseeing the restriction may not be too cumbersome for the relevant competition authority since only blatant cases would likely be challenged and rival retailers could be expected to provide the ongoing monitoring (as the source of complaints). Moreover, as seen in Germany, one or two formal challenges (with stiff penalties and associated negative publicity) may be sufficient to deter retailers from using the practice – so making ongoing regulatory costs low.

Major retailers might argue that such a targeted ban would be discriminatory and unreasonable in the sense it would prevent them from using persistent below-cost selling but not their smaller rivals.[147] However, the main competition-distorting effect is likely to arise with retailers possessing market power using the practice, not with retailers generally. If major retailers were prevented from using the practice then it is possible that other (smaller) retailers may continue to use the practice as a promotional footfall creator – but equally it might encourage them to adopt more conventional short-term promotional loss leading and other marketing behaviour. The latter prospect becomes more likely as the major retailers are forced to switch to short-term promotional pricing and more general price discounting to attract customers and so ensure that they do not lose share to smaller retailers still using persistent below-cost selling. Thus the measure is likely to spread the intensity of competition over a greater range of products than just the leading KVIs as the major retailers are forced to become more imaginative in their promotions. In turn, smaller retailers may then find they have less incentive to use persistent below cost selling, as they are no longer forced to do so in order to match the major retailers. As the nature of promotions change in the market, then small retailers may become obliged to compete on a more general offering, rather than just focus on the same limited lines, and thus similarly switch to more short-term promotions.

In other words, unlike a blanket ban on below-cost selling that constrains competition and possibly facilitates tacit collusion (e.g. as appears to have been the case in France under the 1996 *Loi Galland*)[148], a targeted ban may enhance and stimulate competition. Such a move could free retailers from a need to match rivals with constant below-cost pricing on certain goods (i.e. driven by distorted competition which once begun traps retailers since individually no retailer will wish to be seen to set higher prices on critical KVIs than any of its rivals).[149]

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[147] For instance, see *Tesco Main Submission to the Competition Commission (CC) Inquiry into the UK Grocery Retailing Market* (at paragraph 7.20).

[148] For example, Pierre Biscourp, Xavier Boutin and Thibaud Vergé, "The anti-competitive effects of the 1996 Galland Act", presented to IFS Supermarkets Conference, London, 9 December 2006. On theoretical reasons, see Marie-Laure Allain and Claire Chambolle (2005) "Loss-Leaders Banning Laws as Vertical Restraints," *Journal of Agricultural & Food Industrial Organization*, Vol. 3 (1), Article 5.

[149] For example, in its main party submission to the present CC inquiry, Morrison states:

> "We only sell products below cost because we have to do so on certain products in order to remain competitive. It is not something we would choose to do were we not forced into in by the actions of others. The resulting impact is that other prices in our stores are higher than they would be if we did not need to sell some products at a loss to remain competitive.
>
> This is because we require a budgeted gross profit mix relative to the costs of running our business and the requirement to make an acceptable return on sales and on the investment in our asset base. This gross margin requirement would not change were loss leaders unnecessary. The prices of the latter would, of course, be higher but other products would no longer require the higher gross margins to compensate for loss leaders."

(Wm Morrison Supermarkets plc, *Market Investigation: Retail Grocery Supply in the UK – Main Party Submission*, at page 6).

At the same time, such a move might prevent powerful retailers from using persistent below cost selling as a predatory device and instead encourage them to compete on a more general offering – with broader value for money for consumers than simply based on the prices of a limited number of KVIs (e.g. a broader range of promotional offers, lower prices for non-KVIs and perhaps greater encouragement for bargain hunters to shop-around on a wider selection of goods). Thus, far from being a discriminatory move, this targeted approach may allow retailers to escape from their partly self-induced trap and could be seen to stimulate competition in general and be broadly even in its competitive effects on different players in the market. In addition, it would close off a key avenue for major retailers to use their power to behave (whether deliberately or unintentionally) in a predatory manner, and so help ensure that effective competition and broad consumer choice over different fascias prevails in the market as a whole.

How far such a targeted ban would tackle the broader problem of "focused competition" – where the retail emphasis is very much focused on the pricing and promotion of KVIs but where non-KVIs are not fully exposed to competitive pressure – is a moot point. It would help in so far as it might encourage retailers to spread their promotions across a wider range of products. However, consumers' lack of general price awareness across the broad range of products stocked by grocery retailers may still mean that retailers continue to focus their promotions on staple items and well-known brands. As a result, retailers may continue to have an incentive to focus discounting on KVIs, perhaps revolving short-term below-cost promotions around the same set of goods – thereby complying with a ban on persistent below-cost selling but using the cycling of short-term promotions to effect the same predatory outcome. In this case, a targeted ban on persistent below-cost selling may need to be supplemented with other measures that sought to reduce this incentive. One such possibility – discussed in detail below – would be through a consumer information remedy, serving to make consumers more aware of the prices of a broader range of products, and thereby allowing them to make more informed decisions on where to shop and which items to buy to obtain good value for money across a broader range of their shopping needs (rather than relying on prices of a limited set of KVIs as the key indicator of value for money). This would have the double advantage of exposing a wider range of products to competitive pressure and raising consumers' general price awareness, thereby likely intensifying retail competition as a whole.

5.4.2. Restricting Local Price Flexing

In regard to local price flexing, while the major retailers appear to have eschewed this practice at the present time, it is possible that these retailers may choose at some future point to adopt the practice. Accordingly, a voluntary withdrawal from the practice by the leading players may not be sufficient when (without any binding commitments to the contrary) it might resurface, e.g. to be used in conjunction with below-cost selling in a predatory manner (by allowing major retailers to cross-subsidise by raising prices in some local markets to target small retailers in other local markets with excessively low prices). Each practice may be found (again) to be anti-competitive, but it is the combination of the two that can potentially be really damaging and destructive to competition. If a ban on persistent below cost selling for retailers possessing significant market power were regarded as a regulatory step too far (because of concerns about its overall effect on competition, its regulatory cost to enforce and pragmatic concerns about the design of a prohibition), then a ban on price flexing by the major players might represent a more attractive alternative that would at least make it more expensive (and thus reduce the incentive) to use predatory pricing (as it would have to be used across all local markets rather than just selected ones).

Such a ban might be viewed as reasonable given that the big chains have already abandoned local price flexing (at least on regular prices) and now just apply differential pricing across specific store size bands (so that a chain's prices are essentially national within specific size formats, i.e. where store operating costs might be broadly the same). Thus a seemingly not unreasonable proposal would just to turn this "indefinite" move into a "permanent" move by a ban which just affects the big four retailers (i.e. Tesco, Sainsbury, Asda and Morrison), as the most powerful players in the market. This ban would be easy to monitor (not least as small competitors, perhaps through their associations, would help police this ban). It would also just formalise what the big four retailers may claim to being doing anyway. Moreover, it would take into account cost differences in respect of store operating costs differing by store size/format. However, it would also have to cover vouchers, promotions and other indirect means of price flexing to be ensure that retailers not only played by the rules, but by the spirit of the rules as well.

Nevertheless, it may be important to consider whether such a regulatory move might increase the possibility of tacit collusion or give rise to a general softening of competition (for example, with parallel pricing becoming easier with greater price transparency across markets or limiting retailers ability to price aggressively to meet specific local competition). Here, the evidence in respect of market outcomes (e.g. on price levels and price dispersion) since the major retailers stopped using the practice extensively in the last few years may be telling.

It is possible that mandating a move to national price lists (at least by format) for the major players might help ensure that consumers across the country benefit from keen competition amongst the major retailers, rather than just those in areas of intense local competition (as long as it does not affect incentives to carry on serving markets). Even so, such a move on its own may not be sufficient to ensure this benign outcome for two key reasons.

Firstly, with uneven local competition persisting (with consumers facing different levels of store/fascia choice from area to area), retailers would have an incentive to discriminate geographically by means other than pricing (e.g. on product assortment/range, store amenities, store format, etc) thereby affecting the "value-equivalent" prices consumers receive in different locations (i.e. prices that reflect the product and service quality on offer in a chain's different stores). Yet, mandating behaviour on these non-price aspects may be seen as very incursive regulation.

Secondly, while preventing the operation of price flexing by powerful retailers may be viewed as more preferable than allowing its presence (or the possibility of its reappearance), it would still not leave consumers as well off as they could expect if <u>all</u> local markets were instead to display truly effective competition. This is because any national price set by a retailer would be based on its <u>average</u> market power across local markets – e.g. being higher the more local monopoly markets it controlled, and the lower the more perfectly competitive local markets it operated in. Similarly, with local pricing, the average of local prices would depend on the composition of local markets in which the retailer operated – being higher the more local monopoly markets it controlled, and the lower the more perfectly competitive local markets it operated in.[150] Thus, collusion concerns aside, while a move to national pricing may offer consumers a better overall deal than one where retailers use local pricing, that deal would be better still if competition were intense across all rather than some or even most local markets.

The latter point calls for consideration about regulatory moves that could serve to raise consumer choice and intensify competition in areas where competition is presently limited. If this were achievable then retailers would have a substantially reduced incentive to price flex or indeed use other means of geographic discrimination from one store to another, as all stores in a chain would face a similarly high intensity of competition.

5.5. Increasing Consumer Information[151]

An alternative or perhaps complementary approach to a prohibition would be to seek to alter retailers' incentives to use competition-distorting discriminatory practices. This sub-section considers the potential benefits of a remedy concerned with increasing consumers' awareness about general price levels that in the process may serve to promote price competition more widely across product ranges than the present emphasis on the prices of KVIs. The suggested remedy sketched here builds on the consumer information remedy considered but rejected by the CC in 2000 involving retailers posting price lists on the Internet.[152] The notion is similar to the exercise performed by the FSA in providing price comparison information to consumers for different financial services products to stimulate competition through

[150] Specifically, regardless of a retailer uses national pricing or local pricing, its average prices are more likely to reflect its average local market share rather than its national market share. In other words, in retail sectors, national market shares may typically be expected to underestimate a retailer's selling power given that not all competitors are likely to be present in all local markets (and especially not with the same market shares as their national shares).

[151] For full details of the consumer information remedy suggested in this sub-section (including its precise form, intended requirements on parties and supporting economic logic) see Dobson, *supra* note 67 (at pages 46-52). This sub-section provides an outline of the approach rather than operational details.

greater price awareness, except here it is expected that neutral third parties would provide the relevant detailed and summary price comparisons.

From the consumer's perspective, it would be desirable to have accurate and unbiased information on the general price level and as wide a set of individual products as possible, thereby allowing for effective like-for-like comparisons across all the products required. If this were possible, then retailers might be encouraged to compete more broadly across their product ranges rather than simply focussing on the prices of KVIs. In turn, this would offer the prospect of retailers' ending persistent below cost selling as there would be less incentive to cross-subsidise loss-leader products.

At present, most consumers undertake little comparative shopping, tending to stick with one grocery store for their primary shopping needs. As a consequence, consumers are often not either aware of the general level of prices in one store relative to other stores in the area, or of individual product prices across stores. This is despite the emergence of some Internet price comparison services covering grocery prices, but which are limited in respect of their partial coverage (e.g. "Tesco.com/pricecheck" provides a restricted set of comparisons involving all three main rivals, "trollydolly.co.uk" only covers special offers, and "mysupermarket.co.uk" only covers Internet shop operators).

The intention of a consumer information remedy in this context would be for consumers to have easy access to accurate, unbiased and comprehensive price data on all products carried by the major retailers (and other retailers if they volunteered to provide the same data). The medium would be the Internet, with the retailers obliged to post prices on their websites while also supplying a data-feed to neutral third parties to provide appropriate price comparison services.

This facility could be expected to encourage consumers to search on-line for the best deals available in their locality. If retailers were obliged to provide price information

[152] CC (2000), *supra* note 8, at paragraphs 2.568-2.575.

based on the highest price charged for each item in any of their stores (at least of a certain format) then they would have a direct incentive to desist in price flexing.

Thus the competition benefits from the widespread dissemination of pricing and availability information could be threefold: (i) encouraging price competition on a wider range of products and in process encouraging a move away from persistent below cost selling on certain KVIs; (ii) encouraging a move away from price flexing and for prices to be lowered in areas where local competition is weak, and (iii) encouraging more general price competition by reducing retailers' incentives to raise prices on individual items above competitive levels (for fear of being undercut).[153]

A further benefit of this remedy could arise through consumers effectively monitoring prices to ensure their accuracy, so minimising regulatory monitoring costs. Moreover, the regulatory burden on retailers to provide this information would not appear as great as the CC claimed in 2000 – as evident by Tesco's decision to extend its price comparison service into a weekly updated survey covering over 10,000 items, and other retailers posting prices on the Internet as part of their on-line shopping services.

Finally, while it might be considered possible that the greater price transparency offered by this remedy would facilitate tacit collusion, there is no evidence to suggest that Tesco Pricecheck and other existing price comparison websites or long-running price surveys (e.g. conducted by *The Grocer*) have led or are likely to lead to this outcome. Retailers will continue to face an incentive to differentiate their positions – especially if their retail proposition lays special emphasis on distinct service or product quality – rather than simply price match on every item. Furthermore, each retailer in the market already carries out detailed price comparisons against its rivals and this has not resulted in any supportable claims that this allows retailers to tacitly

[153] In particular, it there is a distinct possibility that average prices would fall in response to increased consumer price sensitivity. This result has been found with previous grocery store information programmes conducted in other countries. For example, work undertaken by the Food Price Review Board of Canada showed that relative prices fell by 6.5% while price comparison information was collected and results reported in newspapers. A similar study in the US found that relative prices declined by 0.2% to 3.7% while comparative price information was made available to the public. Furthermore, both the Canadian and US studies showed that when the information programmes were ended, the average prices rose back to their original levels; thus highlighting that to maintain low prices, information must be continuously supplied. For further details, see Dobson, *supra* note 67.

collude. Indeed, one obvious benefit for the retailers would be that this remedy would allow them to forego the need to conduct their own individual surveys.

5.6. Reducing Local Market Power

Another means of altering underlying incentives to adopt anti-competitive behaviour would be to consider remedies that directly impact on market structure. In particular, if competition is uneven across local markets then measures may be sought to spread the intensity of competition more widely. This unevenness may take two forms. First, there could a lack of consumer choice over stores in certain areas. Second, there could be a lack of consumer choice over fascias in certain areas.

5.6.1. Reducing Planning Restrictions

Where the underlying competitive problem is due to the presence of local market power (occurring generally or in pockets) arising from a lack of consumer choice over stores then remedies should be considered that reduce entry barriers to allow for the opening of additional stores. Reducing planning restrictions may make sense in this case, where the lack of stores is not simply down to the market being thin (e.g. due to low population densities as might be experienced in more remote rural areas).

However, some caution is needed in advocating a move to a very unrestricted planning regime, since this may disproportionately benefit only certain retailers and may have other unintended consequences. Specifically, this move could work to the advantage of very large format operators in opening stores in very advantageous locations that may simply serve to extend their own local market share (when they are already present in the same local area) while having a disproportionately detrimental impact on smaller rivals that have high sunk investments in their existing sites (typically in town centres and neighbourhood shopping districts rather than in the edge-of-town or suburban locations favoured by large format operators). The upshot could be that the new store operator is conferred (by the change in planning regulations) a distinct (second-mover) competitive advantage over certain existing rivals, potentially undermining the strategic value of their investments, thereby detrimentally impacting their local positions and perhaps overall local viability to the detriment of consumer choice (in respect of available fascias to choose between) if they were subsequently forced to exit the market.

5.6.2. Store Divestments and Store Swaps

Alternatively, where the source of local power is a lack of consumer choice over different fascias (i.e. due to local consolidation in favour of particular retailers allowing them to possess unusually high market shares, e.g. in so-called "Tesco Towns"[154]) then remedies should be considered that spread the intensity of local competition.

This might be achieved through enforcing store divestments in areas where fascia choice is particularly weak but where store choice is otherwise sufficient. Such a move might be seen as unfairly targeting particular retailers and undermining their competitive efforts to build up strong positions, when it amounts to simply taking away their market share and giving it to rivals. However, it might be possible to arrange a programme of selective store divestitures mostly operated through "store swaps" along with certain "land bank" disposals that could be designed in such a fashion that this would result in a broadly neutral effect on retailers' existing relative positions (by leaving existing national market shares largely unchanged overall).

The advantage of such a move would be that, while national positions may be little altered, choice at the local level could be significantly enhanced. In particular, such a move could provide an important stimulus to local competition and advance consumer fascia choice by ensuring a more even playing field across all the local markets that make up the UK national market. This, therefore, has the potential to spread the intensity of local competition across local markets more broadly, while reducing retailers' incentives to use local price flexing and other forms of competition-reducing geographic discrimination that take advantage of uneven local competition.

In 2000, the CC rejected the idea of requiring divestment of stores in those areas where price flexing was a problem, arguing that this would be "wholly

[154] See note 53 above.

disproportionate"[155]. However, developments in the market and more recent regulatory decisions suggest that this argument may no longer be valid to the same degree.

First, consolidation has continued apace in the sector, advanced by continued organic growth (with new store openings and store extensions by the major chains) and acquisitions (notably the Morrison/Safeway merger and the acquisitions by Tesco and Sainsbury of various convenience store chains). This has increased national market shares but has likely increased local market shares by proportionately more – given that the growth patterns of each of these chains vary across the local markets that make up the national market. The important point here is that market power in retail markets (because they are inherently local in nature) is not simply measured by national shares but also by the average of local shares.[156] With high average local concentration comes greater risk that average prices will be higher than they would be otherwise in more competitive circumstances (associated with lower levels of average local concentration and greater dispersal of leading retailers' national market shares across local markets).

Second, as witnessed by the CC's decisions in respect of Safeway/Morrison[157] and Somerfield/Morrison[158], enforced store divestments can offer a practical means to

[155] CC (2000), *supra* note 8, at paragraph 2.576.

[156] Thus an isolated local monopolist as a single store operator may have a tiny national share but could still command high prices by exploiting its grip on its local market. Similarly, for given national market shares, the more concentrated are local markets in which multi-market retailers operate, then the greater the prospect that they can operate with higher prices than if their national market shares were spread more evenly across local markets (resulting in lower levels of local market concentration and thereby greater likelihood of more intense competition). This is regardless of whether retailers use local pricing or national pricing, since the weighted average prices in both cases would reflect their average market position across the local markets served. Thus to take an extreme example of a more general principle, consider two hypothetical scenarios involving two retailers each having half the national sales in a given national market made up of two distinct equal-sized and otherwise identical local markets. In the first scenario, the retailers operate in isolation with one retailer a monopolist in one local market, and the other retailer a monopolist in the other local market. Both retailers would then price at the monopoly level in their respective local markets. In the second scenario, the retailers have the same shares in the same two local markets, with neither retailer possessing a competitive advantage over the other retailer but both competing equally for local customers. Unless the rivals colluded, competition (even if imperfect) would ensure that the (average) price set by each retailer would be less than the monopoly level. The point being is that higher national shares may set the platform for possessing market power (especially in regard to gaining economies of scale and buyer power), but it is local shares that may ultimately dictate the extent to which market power can be exercised.

[157] CC (2003), *supra* note 6.

[158] CC (2005), *supra* note 76.

ensure that local competition remains effective. Moreover, as the CC has shown in its own (albeit simple) calculation of benefits from such enforced disposals, the savings to consumers can be very significant.[159]

Accordingly, it would make good sense for the CC to undertake a cost-benefit analysis of an appropriate store divestiture programme and then make a judgement on whether such a remedy would or would not be proportionate in effect, given that once initiated this measure could set the industry on a more competitive course to the continued benefit of consumers.

Conclusion

There are no doubt plenty of other policy options that the CC might consider beyond the possible remedies outlined here. However, one would hope that if the CC were again to conclude that discriminatory practices were having an anti-competitive effect on the retail grocery market then it could recommend specific action to deal with them (or at least lessen their effects). The alternative, of simply letting these practices carry on being used in an anti-competitive form, would likely necessitate yet another inquiry a few more years down the line, at which point competition may be irreversibly damaged.

The prime concern is likely to lie with the market power of the main players in the sector. It is their use of anti-competitive practices that is likely to do the greatest damage to competition and greatest harm to consumer welfare. If this were found to be the case with certain discriminatory practices then it would be appropriate that the main thrust of any remedies would be to tackle this behaviour. This suggests adopting a targeted approach focused on the retailers with the most significant market power and in the contexts (e.g. local markets and consumer segments) that are most

[159] In the case of Somerfield being required to divest 12 mid-size stores purchased from Morrison, the CC estimated that the consumer benefits arising from this remedy amounted to £5.5m per annum. See Competition Commission, *Estimated costs to consumers of the mergers against which the CC took action between March 2005 and March 2006*, available at http://www.competition-commission.org.uk/our_role/analysis/estimated_costs_to_consumers_of_the_mergers.pdf. For further details on these required divestments, see CC (2005), *supra* note 76.

susceptible to consumer detriment arising as the result of market power being exercised or extended.

It may then appear ironic (but actually not) that perhaps the best way to tackle the anti-competitive effects of discriminatory practices may be to use remedies that ostensibly appear discriminatory themselves (in predominantly seeking to tackle the behaviour of the most powerful retailers). However, just as discriminatory practices can in the right circumstances promote competition and advance consumer welfare, ostensibly discriminatory remedies can have the same effect. By altering the behaviour of the powerful retailers, then this may act as a spur to broader changes in the market, which ultimately are not discriminatory or relatively disadvantageous to these powerful players but simply part of a process of making competition more effective in delivering better outcomes to consumers.

More importantly, the source of any significant anti-competitive effects is likely to lie with those firms possessing significant power in a broad range of local markets served. Accordingly, tackling their ability to behave in such a way that is detrimental to consumer interests should take prime concern with any prescribed remedies to ensure that effective competition prevails. In this context, the present CC inquiry needs to consider the underlying causes and effects of competition that is, or over time will likely become, ineffective (especially in view of the distinctly asymmetric positions that have emerged in this sector and the extent of relative size advantages).

As a final comment, the remedies outlined above have been reviewed separately, and may be considered using in isolation. However, it is entirely possible that, should significant anti-competitive effects be identified, a combination of remedies may work best in alleviating or removing these effects. Such a combination might be better placed to tackle different aspects of the direct effects as well as the underlying basis for employing competition-distorting practices. This may then offer greater prospects for promoting and securing effective competition in a sustainable form across the market as a whole, to the ongoing benefit of consumers and the general economic advancement of the sector.