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THE ONLINE MAGAZINE FOR GLOBAL COMPETITION POLICY

# Defining Product Markets in the UK Grocery Industry

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### I. INTRODUCTION

On April 30, 2008, the UK Competition Commission (“CC”) published the final report of its two year investigation into the supply of groceries in the UK.<sup>1</sup> This article gives a UK perspective on some of the issues covered in the recent *Whole Foods*<sup>2</sup> decision by the U.S. Court of Appeals for the District of Columbia. It draws out the key market definition findings in the CC’s investigation, with a particular focus on the CC’s decisions and analysis with respect to those grocery retailers offering a somewhat differentiated product from the UK’s mainstream grocery retailers.

The CC’s investigation into the UK groceries sector was a market investigation under the provisions of the Enterprise Act 2002, which requires the CC to decide under s.134(1) whether “any feature ... of each relevant market prevents, restricts, or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.” Where the CC identifies such a feature there is said to be an

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<sup>1</sup> COMPETITION COMMISSION, MARKET INVESTIGATION INTO THE SUPPLY OF GROCERIES IN THE UK (April 30, 2008) [hereinafter “Groceries Market Investigation”] available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2008/fulltext/538.pdf](http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538.pdf).

<sup>2</sup> *FTC v. Whole Foods Market, Inc.* 533 F.3d 869 (D.C. Cir. July 29, 2008)

‘adverse effect on competition’ (“AEC”), and the CC then decides on the action, if any, that should be taken by itself or by others to remedy, mitigate, or prevent the AEC.

Defining the product and geographic markets in which grocery stores compete was a key building block for the CC’s groceries market investigation, providing the framework for the CC’s analysis of competition among grocery retailers. The CC’s guidelines state that “the Commission does not regard market definition as an end in itself, but rather as a framework within which to analyze the effects of market features.”<sup>3</sup> Nevertheless, in this case the CC’s market definition findings perhaps have greater significance in that they are likely to influence future Office of Fair Trading (“OFT”) inquiries in the sector.<sup>4</sup> In particular, in grocery retailing mergers where stores have been divested to satisfy OFT concerns, the OFT had previously used the market definition arrived at by the CC in earlier groceries inquiries to identify a set of effective competitors that were eligible to purchase divested stores. This experience means that a number of grocery retailers have an interest in the CC’s market definition findings in this investigation that go beyond their implications for the CC’s competitive analysis.

## **II. BACKGROUND**

In 2007, an estimated £110.4 billion of grocery sales in the UK were made through nearly 100,000 grocery stores, including both supermarkets and convenience stores (grocery stores smaller than 280 sq. meters or approx. 3,000 sq. feet). Just over 65

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<sup>3</sup>COMPETITION COMMISSION, CC3-MARKETING INVESTIGATION REFERENCES: COMPETITION COMMISSION GUIDELINES, (2003) 10 *available at* [http://www.competition-commission.org.uk/rep\\_pub/rules\\_and\\_guide/pdf/cc3.pdf](http://www.competition-commission.org.uk/rep_pub/rules_and_guide/pdf/cc3.pdf).

<sup>4</sup>Among other responsibilities, the OFT undertakes phase one merger inquiries and investigates matters arising under Articles 81 and 82 of the EC treaty and their equivalents in UK legislation (Chapters I and II of the Competition Act 1998).

percent of UK grocery sales were made by the four largest grocery retailers in the UK (Asda, Morrisons, Sainsbury's, and Tesco) from a combined total of around 3,600 stores. A further 20 percent of national grocery sales were shared among 4,000 stores belonging to an additional four grocery retailers (The Co-operative Group (Co-op), Marks & Spencer (M&S), Somerfield, and Waitrose).<sup>5</sup>

Within this group of eight large grocery retailers there is a degree of product differentiation. For example, M&S and Waitrose place an emphasis on high quality products, while Asda emphasizes its price competitiveness. There is also differentiation in terms of the store formats offered by each of these retailers. For example, Asda and Morrisons operate very few stores smaller than 1,000 sq. meters (approx. 10,800 sq. feet), while Sainsbury's and Tesco operate large and mid-sized supermarkets as well as convenience stores.

While grocery retailers in the UK offer premium, natural, and organic products, the Premium, Organic, and Natural Supermarkets ("PNOS") segment that is occupied by, among others, Whole Foods and Wild Oats in the U.S, does not have a ready equivalent in the UK. M&S and Waitrose occupy a premium niche in the UK groceries market, but neither has the same focus on fresh organic produce as the U.S. PNOS retailers. M&S, for example, is known for its premium ready meals with a national sales share of 21.2 percent compared to a national groceries sales share of 3.3 percent. Whole Foods has, however, entered the UK in recent years with the acquisition of the seven store Fresh &

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<sup>5</sup>The Co-operative Group announced its acquisition, subject to regulatory clearance, of Somerfield on July 16, 2008.

Wild chain in 2004 and the opening of a flagship store in Kensington, London in 2007. It has told UK competition authorities that it intends to open at least 40 stores in the UK.

The UK, however, has other grocery retailers that differentiate their product from mainstream grocery retailers. One example is the Limited Assortment Discounters (“LADs”) that are active in many grocery retail markets in Europe, offering a limited range of grocery products at very low prices. The major LADs in the UK are the German chains Aldi and Lidl and the Danish-owned Netto. Together, Aldi, Lidl, and Netto operate around 1,000 stores in the UK and generate around £3.1 billion in annual sales.

A further group of grocery retailers in the UK that engage in a substantial degree of product differentiation from mainstream grocery retailers are the frozen food retailers. Frozen food retailers, as their name implies, offer a substantial range of frozen products, including red meat, fish, chicken, vegetables, ready meals, desserts, and other products, as well as a more limited range of fresh produce and dry goods. A typical frozen food store might have around 60-70 percent of its net sales area dedicated to freezers with the remainder for other products. The UK’s largest frozen food retailer is Iceland, which has around 680 stores and annual sales of approximately £1.6 billion. In frozen foods, Iceland has a national sales share of 11.9 percent compared with a national groceries sales share of 1.7 percent.

### **III. THE CC’S FINDINGS ON MARKET DEFINITION**

In defining the product market for grocery retailing the CC focused on two observable variables, store size and the identity of the store operator (store fascia), that it

considered captured many of the factors that differentiate one grocery store from another.<sup>6</sup>

In relation to store fascia, the CC found that, subject to its product market findings on store size, stores belonging to each of the eight large grocery retailers identified above (Asda, Co-op, M&S, Morrisons, Sainsbury's, Somerfield, Tesco, and Waitrose) were in the same product market. The CC also found that Whole Foods' stores of an equivalent size should be included in the same product market as stores belonging to these other grocery retailers. However, in relation to the stores belonging to the LADs and frozen food retailers, the CC found that an asymmetric competitive constraint was present. While LADs and frozen food stores were competitively constrained by stores belonging to the eight large grocery retailers, the LADs and frozen food stores did not themselves impose a competitive constraint on the stores of the eight large grocery retailers.<sup>7</sup>

The finding of asymmetric competitive constraints in relation to store fascia was mirrored in the CC's findings in relation to store size. The CC found that grocery stores larger than 1,000 to 2,000 sq. meters placed a competitive constraint on each other (subject to its findings on store fascia) as well as on smaller supermarkets and convenience stores. Similarly, it found that mid-sized supermarkets between 280 sq. meters and 1,000-2,000 sq. meters imposed a competitive constraint on each other as well

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<sup>6</sup>This approach was somewhat different to that applied in previous investigations in the groceries sector where a shopping mission approach to market definition had been used. Under this approach, the CC identified three primary shopping missions—main (or one-stop), secondary, and convenience shopping. It then considered the extent to which different grocery stores could effectively meet the requirements of these different shopping missions. The grocery stores that were identified as being effective substitutes for each other for customers carrying out each type of shopping mission were then described in terms of store size and store fascia. (Groceries Market Investigation, *supra* note 1, at 50.)

<sup>7</sup>The CC also made findings regarding the treatment for market definition purposes of smaller grocery retailers, but for the sake of simplicity we do not discuss these in this article.

as on convenience stores (grocery stores smaller than 280 sq. meters). Grocery stores in smaller size categories were competitively constrained by stores in larger size categories but did not themselves impose a competitive constraint on larger stores.<sup>8</sup>

In reaching its findings on store fascia, the CC relied on evidence in four areas: (1) grocery retailers' monitoring of their competitors; (2) an analysis of the effect that entry by grocery stores belonging to particular retailers had on other retailers' store revenues (the entry analysis); (3) an econometric model of consumer demand; and (4) a general consideration of the product range offered by different grocery retailers. The following paragraphs focus on the evidence the CC relied on to reach a market definition finding relating retailers (M&S, the LADs, and the frozen food retailers) with a significantly differentiated product to the mainstream grocery retailers. In Section 4 we discuss the CC's interpretation of this evidence in the context of the Small but Significant Non-transitory Increase in Prices ("SSNIP") test as well as the reasons why the CC didn't use other types of analyses, such as critical loss analysis and diversion ratios, in their investigation.

The CC's decision to include M&S in the same product market as other large grocery retailers in the UK stands in contrast to the CC's decisions in previous groceries sector investigations in which M&S was excluded from this market. In 2000, the CC excluded M&S from the same product market as other mainstream grocery retailers on

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<sup>8</sup>Asymmetric competitive constraints were also identified in relation to the geographic market where the CC found that: (a) larger grocery stores will, in general, be constrained by other larger grocery stores within a 10- to 15-minute drive-time; (b) mid-sized grocery stores will, in general, be constrained by other mid-sized stores within a 5- to 10-minute drive-time and by larger grocery stores within a 10- to 15-minute drive-time; and (c) convenience stores will, in general, be constrained by other convenience stores within a 5-minute drive-time, by mid-sized stores within a 5-10 minute drive-time and by larger grocery stores within a 10-15 minute drive-time.

the grounds that “it offers only M&S own-label goods, lacks the full food product range needed for one-stop shopping, generally does not offer flat car parking and has a much more limited range of non-food grocery products than we consider is needed to meet one-stop shopping needs.”<sup>9</sup>

However, in including M&S in the same product market as other mainstream grocery retailers in its market investigation report, the CC refers to its entry analysis—which showed that the entry of a new M&S store had an impact on the revenues of Asda, Tesco, and Sainsbury’s stores in the locality. It also notes that while “M&S carries fewer Stock Keeping Units (“SKUs”) compared with other large grocery retailers in stores of comparable sizes ... [it] does carry the same broad product range ... but has fewer SKUs within each product category as it only stocks own-label products.”<sup>10</sup>

The CC’s consideration of product range and its entry analysis were also central to its product market findings concerning the LADs. It noted that LADs stores carry 1,000 to 1,400 product lines in stores ranging from 500 to 1,400 sq. meters, while stores of a similar size operated by one of the large UK grocery retailers carry around 5,000 products. It also noted that its entry analysis results indicated that Aldi, Lidl, and Netto were not close substitutes for the stores of large grocery retailers. However, the CC considered that a hypothetical monopolist of the LADs stores would not be able to profitably impose a significant price increase due to customers switching to the mid-sized and larger stores of the mainstream grocery retailers. As a result, the CC found that there

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<sup>9</sup>COMPETITION COMMISSION, SUPERMARKETS, A REPORT ON THE SUPPLY OF GROCERIES FROM MULTIPLE STORES IN THE UNITED KINGDOM (2000), 21 available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2000/446super.htm](http://www.competition-commission.org.uk/rep_pub/reports/2000/446super.htm).

<sup>10</sup>Groceries Market Competition, *supra* Note 1, at 67.



was an asymmetric competitive constraint between LADs stores and those of mainstream grocery retailers. The CC applied the same reasoning to reach similar findings in relation to frozen food stores.

#### **IV. MARKET DEFINITION AND THE SSNIP TEST**

The methodology employed by the CC to reach its market definition findings, consistent with its guidelines, was that of the hypothetical monopolist or SSNIP test. The various different types of analysis and evidence referred to above (price monitoring behavior, entry analysis, modelling of consumer demand, and product range) were used to inform an overall assessment of likely consumer behavior when faced with a price increase at the store where they shopped as well as whether a hypothetical monopolist could profitably impose a small price increase. That is, the SSNIP test provided a conceptual framework in which the CC could assess all the relevant evidence rather than being a test that was applied directly in a single model on which the CC relied for its findings.

The CC and the OFT have both used critical loss analyses, such as those based on diversion ratios and profit margins, to provide a direct application of the SSNIP test in recent grocery retailing merger investigations. For example, in the CC's investigation of the acquisition of 115 Morrisons stores by Somerfield<sup>11</sup> and the OFT's investigation of the merger between Co-op Group Limited and United Co-op<sup>12</sup> survey evidence and

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<sup>11</sup>COMPETITION COMMISSION, SOMERFIELD PLC/WM MORRISON SUPERMARKETS PLC: A REPORT ON THE ACQUISITION BY SOMERFIELD PLC OF 115 STORES FROM WM MORRISON SUPERMARKETS PLC: (2005) available at [http://www.competition-commission.org.uk/rep\\_pub/reports/2005/501somerfield](http://www.competition-commission.org.uk/rep_pub/reports/2005/501somerfield)

<sup>12</sup>OFFICE OF FAIR TRADING, MERGERS- ANTICIPATED MERGER BETWEEN CO-OPERATIVE GROUP (CWS) LIMITED AND UNITED CO-OPERATIVES LIMITED (July 23, 2007) available at [http://www.offt.gov.uk/shared\\_offt/mergers\\_ea02/361227/Co-op.pdf](http://www.offt.gov.uk/shared_offt/mergers_ea02/361227/Co-op.pdf).

information on margins were used to assess the extent to which a merger might reduce competitive constraints in each locality.<sup>13</sup>

However, such a modelling exercise was not undertaken in the groceries market investigation. The diversion ratio analysis performed in the Somerfield case, for example, was based on survey results at 56 stores where the merger might create a competition problem. In the groceries market investigation such an exercise was far less feasible where many thousands of stores were being examined. The scope of the market definition exercise in a market investigation is considerably broader than in a merger inquiry. Many different starting points for a SSNIP test need to be considered and each of these different starting points can lead to a different market definition outcome. Further, the longer time period required by a market investigation opens up the possibility of using the entry analysis and demand modelling referred to above, which is not always possible in the shorter time frames of a CC merger inquiry.

Nevertheless, in the context of geographic market definition, a model was submitted to the CC that sought to directly apply the SSNIP test by simulating customer movements to other stores following a price increase at an individual store.<sup>14</sup> It was argued that as this model was a direct application of the SSNIP test, the CC should give substantial weight to it over and above that accorded to other evidence it was reviewing.

In contrast to those approaches that use survey evidence to inform the extent to which customers might shift between stores, the model assumed that customers would

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<sup>13</sup>Graeme Reynolds & Chris Walters, *The Use of Customer Surveys for Market Definition and the Competitive Assessment of Horizontal Mergers*, 4(2) J. COMPETITION L. & ECON.:411 (2008).

<sup>14</sup>See Tesco, *Geographic Market Definition in the Groceries Inquiry* available at [http://www.competition-commission.org.uk/inquiries/ref2006/grocery/main\\_party\\_submissions.htm](http://www.competition-commission.org.uk/inquiries/ref2006/grocery/main_party_submissions.htm)

switch to a new store provided that the cost of travelling to, and shopping at, the new store was less than the cost of shopping at the store with increased prices. Consumers were modelled as a group at the Census Output Area level, and each consumer was assumed to have a uniform cost of travel. In assessing whether a price increase was profitable, each store was assumed to have a uniform profit margin. At least initially, the model predicted significant customer movements following a 5 percent price increase at a store, which questioned the model's usefulness. In some cases, it resulted in a store losing all its customers, and in other cases it resulted in neighboring stores more than doubling their customers. These somewhat extreme predictions were modified in later model extensions, including when simulations were based on smaller price increases. The model at this point produced results consistent with other evidence on the scope of the geographic market.<sup>15</sup>

Despite this, the CC placed only limited weight on the results generated by this model due to its concerns regarding the underlying methodology and other factors. In doing so, the CC stated that '[e]conometric analysis and other modelling cannot, in isolation, provide a definitive answer to the question of market definition',<sup>16</sup> and needs to be considered alongside other evidence.

## **V. CONCLUSION**

The CC's finding of asymmetric competitive constraints between more specialized supermarkets and more mainstream grocery stores in the UK provides an

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<sup>15</sup>The CC, like the FTC in the Whole Foods case, stated that the appropriate price increase for assessing the relevant market for the supply of groceries is likely to be less than 5 percent.

<sup>16</sup>Groceries Market Investigation, *supra* note 1, at 49.

interesting contrast with the finding of a separate product market for PNOS retailers in the United States. This contrast does not, however, seem to reflect any great difference in approach as similar evidence and analytical approaches were adopted by both the FTC and the CC in each case. Rather, it would seem to reflect differences in consumer behavior and competitive offerings in grocery retailing in the US and the UK.