11 The relationship between the main parties and their suppliers

Contents

Introduction

11.1. In this chapter, we examine the relationship between the main parties and their suppliers. As shown in Table 10.1, the cost of buying the goods they sell comprises the major part of grocery retailers' costs. Hence, the nature of this relationship has a significant impact on their ability to meet the needs of their customers. The main parties depend on their suppliers to provide the goods that they sell at the right time, in the right quantity, of appropriate quality and at a competitive price. Equally, in many cases, main parties take a large proportion (often all) of their suppliers' output, so many suppliers are also dependent on their main party customers. In his Press Release relating to the reference of the grocery retailing sector to the CC (Appendix 3.1), the DGFT said that the size of the supermarket operations had brought them tremendous buyer power which could be used to deliver better quality and lower prices to customers, but he was concerned that this power might become exploitative. He said that the many responses from suppliers during the OFT inquiry suggested that 'this was an area which needed to be looked at by the Commission'.

11.2. Both the main parties and suppliers stressed to us that it was vital that the relationship worked well. However, they have differing objectives (put simply, suppliers want to sell at the highest price they can and retailers want to buy at the lowest costs to themselves), so some tension is inevitable. It appears that, as price competition has increased, so this tension has also increased.

11.3. We asked the main parties and suppliers what they thought about their relationships with each other; the extent to which the relationship was balanced; and to what extent main parties were able to exert undue pressure on some suppliers, or vice versa. In order to ascertain their views, we sent questionnaires to the main parties and to a sample of their suppliers. Each of the main parties responded and we received 340 responses from smaller suppliers, together with 57 responses to a more detailed questionnaire sent to larger suppliers (LSQ). The questionnaires are discussed further in Appendix 11.1. A summary analysis of the responses to the smaller suppliers questionnaire (SSQ), together with the additional comments made by smaller suppliers (without identifying individual retailers), are in Appendix 11.2.

11.4. We also received a large number of letters and submissions, and held hearings with several individual suppliers. A variety of concerns was raised. Several suppliers stated at hearings that there had been significant changes in the market place and in the demands of main parties during our inquiry. Representative of this were the comments of one large supplier which said that, following the acquisition of Asda by Wal-Mart, the supplier's other major customers were reconsidering their strategies. Main parties were competing very intensely, but individually; different retailers were responding in different ways. There were increasing demands on suppliers for up-front payments, which had not previously been sought. Some multiples were not honouring historical payment terms for promotions. Agreements which had formerly been over a longer term were now being offered for retendering at short notice. This supplier thought that there had been a reduction in the general level of integrity and that the relationship between retailers and suppliers had become more adversarial.

Types and numbers of suppliers

11.5. The main parties sell a large range of goods—for example, a Sainsbury store's grocery range is, typically, between 18,000 and 25,000 product lines (see Table 5.12)—obtained from many suppliers. The approximate number of suppliers to the five largest purchasers of groceries for resale (the major buyers) (see paragraph 5.24) as at January 2000 is shown in Table 11.1.

TABLE 11.1 **Approximate numbers of suppliers to the major buyers (as at January 2000)**

Major buyer	*Number of suppliers*
Asda	2,000
Safeway	2,000
Sainsbury	2,400
Somerfield	1,600
Tesco	2,600

Source: The companies.

11.6. These suppliers range from large multinational conglomerates, with worldwide sales of over £25 billion, through national groups to specialist cottage industry providers, with sales of under £1 million. 6.5 per cent of the SSQ respondents were independent companies with an annual turnover of less than £1 million.

11.7. An analysis of the UK sales quoted by respondents to both questionnaires is given in Table 11.2. The way the samples were selected means that these figures overestimate the proportion of larger suppliers.

TABLE 11.2 **Distribution of questionnaire respondents by turnover**

Annual turnover £m	*Suppliers %*
0–1	13.6
1–10	36.4
10–50	29.1
50–100	8.5
100–250	4.8
250–500	3.3
Over 500	4.5

Source: CC survey.

11.8. Suppliers of branded goods want wide distribution for their products, and hence generally seek to trade with all the multiples that sell them. However, most suppliers of fresh fruit and vegetables, meat, poultry and some retailers' own-label chilled products appear to concentrate on trade with a limited number of the main parties (often four or less).

11.9. Many manufacturers of branded goods also supply retailers' own-label products, which compete with the manufacturer's branded products. Other manufacturers (including some of the largest suppliers) are not prepared to supply both branded and directly competing retailers' own-label products. Some companies specialize in retailers' own-label products and either do not produce branded goods, or produce only secondary or tertiary branded products.

Dependence of suppliers on main parties

11.10. As noted above, the main parties depend on suppliers for all the goods they sell; and suppliers, in theory, have the option of selling to retailers other than the main parties. In practice, however, most suppliers sell most of their output to the main parties. For example, the largest four main parties account for over 70 per cent of the UK sales of the two major competing brands of washing powder, Persil and Ariel. Many smaller suppliers are dependent on a single multiple for all their sales ('solus supply').

11.11. The main parties and their suppliers gave very different views on their interdependence. We were told by some of the main parties that they were much more dependent on certain suppliers than the suppliers were on them, especially where 'must stock' brands were concerned. However, a typical response from one supplier was that, whilst it might be in a position of equal power if it only produced the 'must stock' brands, the main parties were able to exert pressure during price negotiations on all the supplier's products by threatening to delist some of its more peripheral brands. In addition this supplier pointed out that each of the largest main parties accounted for up to 20 per cent of its total business, while the supplier's business represented a very small proportion of the total business of each of these multiples.

11.12. Some main parties made the point that individual UK retailers purchased a very small part of the total output of large multinational companies. For example, in the year to June 1999, Procter & Gamble had worldwide sales of about $38 billion (about £24 billion). Procter & Gamble UK sales (excluding snacks and soft drinks) were about £1.2 billion—some 5 per cent of the parent group turnover. Sales to UK multiples represent about 3.3 per cent of worldwide sales, with the largest (Tesco) representing 0.85 per cent. However, the emergence of global retailers is changing these proportions. For example, Asda in the UK amounts to 0.47 per cent of Procter & Gamble's global sales, but sales to the Asda/Wal-Mart group now amount to approximately 13 per cent of Procter & Gamble's global sales. It should also be noted that large suppliers invest considerable sums in their major brands, and it is an essential part of their strategy that nationally promoted brands are widely available, particularly at the large retailers which account for 10 to 20 per cent of their potential UK sales.

11.13. Some large UK suppliers which were members of multinational groups said that price negotiations were managed independently of their parent groups.[1] One such large supplier told us:

> Price negotiations take place on a 'by product' basis. It is extremely difficult to leverage negotiation power using size of business in another area as a lever; in some cases to do so could be considered unlawful. In fact there is an argument that a smaller producer of non-strategic products may face less pressure on issues such as overriders, as customers will expend more effort on the larger suppliers to offer potentially greater benefits in key areas.

11.14. Sales of the LSQ respondents were analysed to show their relative dependence on their largest customers among the main parties (see Table 11.3). For example, sales to respondents' largest three main party customers[2] accounted for between 48.7 per cent and 100 per cent (69.7 per cent on average) of their total sales to the main parties. The same customers accounted for between 19.1 and 100 per cent (56.4 per cent on average) of their total UK sales.

TABLE 11.3 **Dependence of large suppliers on their largest main party customers**

per cent

	Percentage of sales to main parties		*Percentage of UK retail sales*	
Main party customers	*Average*	*Minimum*	*Average*	*Minimum*
Top 1	38.4	18.3	32.2	8.1
Top 2	56.9	35.1	46.8	14.4
Top 3	69.7	48.7	56.4	19.1
Top 4	79.1	60.1	63.3	21.9
Top 5	86.2	70.4	68.5	23.7

Source: CC analysis of supplier information.

Note: Maximum percentage is 100 per cent in all cases.

11.15. Table 11.3 indicates a considerable dependence for an average large supplier, although the degree of dependence varies for suppliers in different sectors. Generally, suppliers of fresh produce appear to be most dependent on their largest main party customers for their sales. Those who supply alcoholic and non-alcoholic beverages, confectionery and snacks are the least dependent on the main parties.

[1]This may be changing; see paragraphs 11.81 and 11. 82.
[2]This includes a few suppliers with only one or two main party customers.

11.16. Large multinational companies constitute a small proportion of the total number of suppliers. We explored this issue further, using Tesco data, since it was the largest of the main parties. From a Tesco list of suppliers for the financial year ending February 1999, we excluded the largest supplier since it supplied tobacco products, which are not groceries.[1] This left 2,619 suppliers and £9.3 billion of purchases.

11.17. Typically, Tesco represents 20 to 30 per cent of the main party sales of large suppliers, which trade with most of the main parties. Smaller suppliers often trade with a limited number of the main parties and for them Tesco may represent a higher proportion of their sales. Tesco is the only main party with which a number of these suppliers, both small and large, trade.

11.18. Tesco's largest supplier of groceries supplies 2.7 per cent of its total purchases. Only eight suppliers have sales representing 1 per cent or more of Tesco's purchases, and only 230 suppliers have sales representing 0.1 per cent or more. The median supplier (by value of goods supplied) sold Tesco £220,000, which represents 0.0024 per cent of Tesco's total purchases.

Concerns of suppliers

Suppliers' views on the relationship

11.19. We asked suppliers about their relationships with the main parties. The responses are summarized in Table 11.4. The larger suppliers were asked to comment on main parties individually, although some preferred to provide aggregated answers. About 40 per cent of the respondents included individual Co-ops in their figures, and these are reported separately from the respondents who counted all Co-ops as a single entity in their figures. Smaller suppliers were asked to provide only a composite answer.

TABLE 11.4 **A summary of suppliers' views of their relationships with main parties**

per cent

	Larger suppliers which combined Co-ops	*Larger suppliers which included individual Co-ops*	*Smaller suppliers**
Excellent	11	5	11
Good	50	54	49
Acceptable	35	36	33
Fairly poor	5	5	4
Bad	0	1	1

Source: CC survey.

*2 per cent did not respond to this question.

11.20. In all three samples about 60 per cent of relationships were classed as good or excellent, 35 per cent as only acceptable, and 5 per cent as poor or bad. This suggests a high degree of satisfaction generally, although there may be a bias in the replies, in that any suppliers with poor or bad relationships with their main party customers are unlikely to remain suppliers for long.

11.21. Despite the favourable view of the relationship given by suppliers in response to these questions, answers to other questions and additional comments made by suppliers indicated that there were several areas of major concern, which are discussed in detail later in the chapter. In addition, we received a considerable number of submissions from suppliers and supplier associations in response to our initial request for information. The majority of these were critical of the main parties, usually generically, and some were extremely hostile. In the hearings that we held with suppliers and their representatives, many concerns over the behaviour of the larger main parties were raised, although some large suppliers that we saw said that relationships were generally satisfactory.

[1]Main parties were asked to exclude petrol, clothing, DIY products and financial services suppliers. There was no easy way to exclude all non-reference sales and excluding the principal tobacco supplier will leave other non-reference suppliers. However, this is not believed to have had a material effect on the analysis, which is only intended to be indicative, and will already be out of date.

11.22. Most suppliers were extremely concerned that their submissions and comments should be kept confidential. Many refused to give evidence or to complete our questionnaires unless we were prepared to guarantee confidentiality and many more refused to identify the relevant main parties (see Appendix 11.1). Even large multinational suppliers expressed concern. Overall, there was a general climate of apprehension. Some suppliers expressed what appeared to be very real fears that any hint of involvement in our inquiry would threaten the existence of their commercial operations. We learnt, for example, that Sainsbury had written to its suppliers telling them of our request for a list of its suppliers. The letter informed recipients that they should be aware that their names had been submitted to the CC, and that they might hear directly from us. It assured them of Sainsbury's continuing commitment to its suppliers. Sainsbury told us that it had written the letter because it had identified concerns among suppliers as to the impact of our inquiry, and out of courtesy to those whose names had been provided. This seemed to us a perfectly reasonable course of action. However, we received some calls from recipients of the letter, suspecting ulterior motives on the part of Sainsbury.

11.23. We assured suppliers that we would maintain their confidentiality in so far as we were able, since it was clear to us that, without such an assurance, we would have had the greatest difficulty in collecting any evidence whatsoever. Even so, many suppliers refused to submit evidence or complete our questionnaire.

11.24. Suppliers believe that the balance of power is generally tilted firmly towards the main parties. For example, we asked suppliers about their negotiating strength in the event of a dispute. Only 27 per cent of large suppliers and 15 per cent of smaller suppliers responded that their negotiating position was adequate.

11.25. As noted above, many suppliers are small compared with the main parties, and are heavily reliant on the major buyers. But subsidiaries of large multinational companies, too, argued that it was extremely difficult to attempt to leverage negotiating power in product-by-product price negotiations, and said that there was little they could do against practices of main parties such as unilaterally deducting amounts in dispute from invoices.

11.26. Many suppliers commented on the purchasing power of the main parties, their ability to drive down suppliers' prices to uneconomic levels and what they saw as their general high-handedness. A consultant to the packaging industry noted that 'the degree and variety of pressure upon the suppliers was extremely alarming—all complied with the retailers' demands because of the dread of de-listing'. (See paragraphs 11.48 to 11.55 for a discussion of delisting.) A small supplier commented: 'The power of the multiples, and especially of young (c.25/28) buyers, without experience, is frightening. [They have] the power to dictate prices and margins, display or not, allocate space and threaten covertly. It's why we would never allow more than 15 per cent of turnover to be supplied to multiples.' Suppliers' organizations were often more willing to speak than small suppliers. One commented that the main parties:

> … talk about partnerships, but these do not exist, and they ruthlessly erode suppliers' margins with no consideration of the damage they are doing to that company or its employees. Multiples switch their buyers around every six to twelve months in order that relationships and loyalty to suppliers can be avoided. The new buyer is given carte blanche to de-list suppliers, who are frequently treated with complete contempt.

Another said that:

> … many of our individual members are extremely reluctant, or refuse point blank, to comment on specific cases. Many of these organisations have 40, 50, 60 or even 70 per cent of their sales with a multiple. The resultant power that the multiples have is huge. This power is often rested in the hands of a small buying team, often young, who are changed at short notice routinely. This makes it extremely difficult to maintain stability within the industry.

11.27. One supplier said that, over recent months, it had been asked by one multiple to make three separate cash contributions: the third, by telephone, was for a sum in excess of £100,000 and was claimed by the multiple as 'a contribution towards profits'. The supplier said that the same multiple had introduced other charges, none of which had been negotiated and all of which had been deducted from the next payment. There had been no recourse to complain for fear of 'upsetting the relationship'. The supplier added that it had been directed by the multiple to use a specified distributor, even if this meant breaking an existing contract with another company. In supporting its claim for anonymity, the supplier said that it would be commercial suicide for any supplier to give a true and honest account of all aspects of relationships with retailers.

11.28. For more views of individual suppliers see Chapter 15.

Main parties' views on the relationship

11.29. The main parties were generally content with their relationships with suppliers. For one, it involved a more collaborative style of trading as a consequence of having joint and long-term objectives. This created a partnership approach with suppliers based on mutual respect. A few main parties told us that they encouraged and assisted smaller or local suppliers, and those with particular difficulties, during, for example, the BSE crisis (see also paragraphs 11.140 to 11.161). Asda told us that it had sourced all its fresh beef from the UK and reduced the price of beef significantly. Tesco said that it had reduced payment terms to beef suppliers during this period and given other improved payment terms to suppliers to help them through cash-flow problems.

11.30. The main parties, on the whole, acknowledged that minor disputes, or differences, with suppliers occurred from time to time, but they said that these were usually resolved at an appropriate management level, through discussion or negotiation. They said that it was extremely rare for legal departments to become involved, a point confirmed by suppliers.

Specific practices of concern to suppliers

11.31. On the basis of information given to us in response to our initial invitation to comment on the inquiry, we asked suppliers to what extent any of the main parties that they supplied engaged in certain practices. The responses of larger suppliers are summarized in Table 11.4; those of smaller suppliers are summarized in Appendix 11.2.

TABLE 11.5 **Practices engaged in by main parties: responses from the LSQ**

per cent

Practice	*Never*	*Rarely*	*Sometimes*	*Fairly often*	*Often*	*No answer*
Delay payments by 15 days more than terms	44	33	18	2	2	2
Delay other amounts due by more than 15 days	32	34	22	7	4	2
Break other contract terms	39	30	12	4	0	16
Change quality agreed without adequate notice	58	25	11	0	0	7
Change other agreed requirements without adequate notice	35	19	26	7	2	11
Threaten delisting without reasonable cause	21	42	32	2	0	4
Require charitable contributions to be made	32	16	37	9	4	4
Require payments/discounts when main party's profit from products is less than the main party expected	26	25	30	11	5	4
Require buyback of unsold goods	47	35	11	4	0	4
Make deductions from returns to cover wastage	54	23	12	2	4	5
Impose slotting charges	44	11	18	5	16	7
Charge for any shelf space	49	19	18	4	7	4
Charge for listing	37	19	25	9	5	5

Source: CC survey.

11.32. Table 11.5 and Appendix 11.2 (Q32) show that, on average, 55 to 60 per cent of the suppliers which answered these questions had some experience of these practices and 30 to 35 per cent experienced them on a more regular basis. Respondents believed that all the identified practices were engaged in by some of the main parties, with varying frequencies. Some practices will not apply to all categories of supplier.[1] Hence, the overall percentages may be considered significant.

11.33. In our questionnaires to suppliers, we used the term ‘require’, for example, in respect of charitable contributions. Some of the main parties had said in their response to the main party questionnaire that they might request such contributions but would not require them. When we subsequently put specific practices to main parties (see paragraph 11.36), we used the term ‘require or request’.

11.34. In their responses to our questionnaires, a large number of suppliers volunteered additional practices of concern, including: the deduction of costs from invoices payable without prior agreement; changes to agreed promotions at short notice, leading to increased costs for suppliers; sole use of service providers designated by the main parties for packaging, labelling and haulage, from whom the main party received a payment; deductions and payments of advertising allowances and overriders (see paragraph 11.89); ad hoc requests for cash payments by main parties, and delisting (see paragraphs 11.48 to 11.55) for a variety of reasons including replacement of branded product by the retailer’s own-label and as a result of category management (see paragraph 11.67). Other comments suggested that main parties tended to favour large suppliers, that there was coercion of suppliers into exclusivity arrangements, that main parties imposed supply chain changes which reduced the main party’s costs but increased the supplier’s costs, and that there were unwarranted administration costs for handling consumer complaints, coupled with little or no documentation about the alleged complaints.

11.35. There was little difference between the responses from larger and smaller suppliers on these matters.

11.36. As noted in paragraph 11.22, many suppliers were concerned about confidentiality and so did not identify which of the main parties carried out each of the above practices, although the indication from the questionnaires was that most main parties adopted some of them in relation to some of their suppliers. Hence, we were aware that these kinds of behaviour were widespread, but did not know which of the main parties were involved. To overcome this problem, we listed 52 specific practices, each raised by a substantial number of suppliers, and sent it in a questionnaire to the main parties, asking them which of the individual activities they had carried out during the five years to 31 December 1999. Provision was made for explanatory comments as and where the recipients felt them to be helpful or necessary. Additionally, in the relatively few cases where a small supplier was prepared to criticize an individual multiple, these were shown to the main party concerned, without naming the supplier. The main parties’ response to our questionnaire and their comments are set out in Appendix 11.3. A summary is shown in Table 11.6. The table excludes a number of practices which the parties did not acknowledge, but which their additional comments suggested that they had carried out, at least in some circumstances (see Appendix 11.3 for details).

[1]Changes in quality standards apply mainly to retailers’ own-label and fresh produce suppliers, whereas slotting/shelf space and listings charges generally apply to suppliers of branded products.

TABLE 11.6 **Summary of responses to the list of 52 practices**

	Number of practices acknowledged
Aldi	6
Asda	29
Booth	21
Budgens	27
Co-ops	23
Iceland	14
M&S	3
Morrison	19
Netto	15
Safeway	23
Sainsbury	13
Somerfield	19
Tesco	7
Waitrose	11

Source: The companies (in many cases subject to comments).

11.37. With the exception of Tesco (and, to a lesser extent, Sainsbury), there was a high degree of correlation between the complaints of suppliers and the responses of the main parties.

11.38. Tesco, in common with some other main parties, drew a distinction between what might have happened occasionally or in error as against its company policy or standard practice. In its initial response, it said that it had responded on the basis of company policy or standard practice. It said that it had carried out some of the practices but we noted that these were fewer in number than for other main parties. We therefore asked Tesco to confirm its response by resubmitting the list and identifying which practices it had actually engaged in during the previous five years. Tesco said that it was difficult for it to answer 'yes' to descriptions that did not match its behaviour and which buyers did not recognize, but on this basis it had engaged in a further four practices, though each of these had been an infrequent or rare occurrence. This took its total to 11, reducing, but not eliminating, the inconsistencies between Tesco's response and the complaints of suppliers.

11.39. We put to Tesco four specific complaints concerning practices where we had documentary evidence:

(a) A suppliers' representative body brought to our attention a letter from Tesco sent to a packhouse instructing that produce from either of two growers that had previously, but no longer, supplied Tesco was no longer to be used in any facility used for Tesco produce. Failure would result in immediate suspension of the packhouse's business with Tesco. The suppliers' representative body told us that the produce had become scarce a couple of weeks earlier because of cold weather; the growers had told their packer that they could not supply him because the price he was offering was too low and Tesco had then sourced the produce from other outlets at a higher price. Tesco told us that its buyer decided that the quality of produce from these two growers was inadequate and that they were no longer going to supply Tesco. Concerned that the quality going into that packhouse for other retailers might find its way into Tesco's supply chain, the buyer had instructed the packhouse not to take produce from these growers. Tesco said that the buyer had no intention of depriving other retailers of stock but was attempting to ensure that products from a supplier with which he had ceased trading did not enter Tesco's order. As this represented a departure from company policy, the buyer concerned had been reprimanded (see also Appendix 11.3, Table 1, Practice ID33).

(b) We were told that a general store in Tredegar had begun undercutting an adjacent Tesco store on the price of bread, supplied to both outlets by a local bakery. The Tesco store manager had allegedly threatened to cancel its contract with the bakery if it did not persuade the general store to increase its price. The general store has since ceased trading. Tesco said it appeared that, following customer complaints, the store manager had spoken directly to the bakery regarding the price differential between Tesco and a nearby store. The bakery subsequently contacted Tesco's Buying Manager to clarify the situation. Tesco assured the supplier that Tesco would continue to carry its products, and would in no way attempt to dictate its trading terms with other

retailers. Tesco added that the store manager in Tredegar at that time was no longer in its employment. It said that it took such complaints seriously. Such behaviour would be against company policy and practice and, therefore, unlikely to happen.

(c) We received a copy of a letter from a Tesco to its suppliers in which it informed them that there were too many invoice queries due to suppliers not invoicing at the correct case cost. The letter said that, in future, if these queries continued after suppliers had been contacted, an administration charge would be raised to cover the costs incurred within Tesco. These charges were as follows: £1,000 for the same query two weeks running, and £1,000 for every week thereafter until resolved. Tesco said that the letter was a notification of a proposed administrative charge in the event of persistent invoice errors. No such charge had actually been deducted from any supplier. Suppliers were warned of Tesco's intention to seek compensation for specific errors or omissions on their part. They then had the opportunity to enter into discussions about the reasons for and levels of such payments. (See Appendix 11.3, ID12.)

(d) Muskaan Limited, a small supplier of ethnic foods, now in receivership, said that one of Tesco's 'Category Managers' had written to the company, in respect of a price-marking problem on an item supplied in the Republic of Ireland (which is not within our terms of reference), to the effect that Tesco would impose fines of £10,000 per product 'in order to focus your business on getting deliveries right in the first place'. Tesco told us that the parameters within which deductions for errors or omissions by suppliers were made were known to suppliers. It said that where errors had occurred, suppliers had been warned of Tesco's intention to seek compensation. Tesco confirmed that letters of the same sort had been sent to suppliers of groceries in the UK.

11.40. Tesco told us that it had not, in the time available, been able to consult all the buyers who had worked for it over the five-year period. Some of the other main parties told us that, concerned by what we had identified as the level of discontent among their suppliers, they had gone to great lengths to ascertain buying practices**.**

11.41. Another practice brought to our attention during our inquiry concerned Safeway. In November 1999, Safeway, prompted by a desire to improve availability of key products, decided to guarantee the availability of 1,000 of its most popular lines. It wrote to the suppliers of those lines asking for a payment of £20,000 per line to help finance, it said, investment in store wages, stockholding and wastage costs. The National Farmers' Union told us that for suppliers of more than one line, the contributions sought were extremely large, and that for small businesses depending on contracts with one or two retailers for their viability the impact would be devastating. Safeway told us that, if sales growth projections were achieved, its suppliers would get a healthy return on this investment very quickly. Where a product line was supplied by several suppliers the contribution Safeway was seeking from each was far less than £20,000 and was being resolved by negotiation. Safeway added that there was no question of this scheme being imposed on anyone. It was, and would remain, a voluntary scheme. If any supplier felt he could not support the scheme, Safeway would withdraw his product and no penalty of any kind would be imposed.

11.42. There were some activities where we had complaints from suppliers naming a main party, and where we put the details to the main parties concerned anonymously, but which the main party concerned maintained that it had not engaged in. There were nine such activities in the case of Tesco and three for Sainsbury, which had also responded to our list on the basis of company policy.

11.43. It was apparent that several of the practices complained about by the suppliers were fairly widespread. Specifically there were 20 practices which five or more of the main parties indicated they had carried out at some time, if not systematically. Full details are set out in Appendix 11.3.

11.44. A number of the main parties criticized our approach. Their comments are given in Appendix 11.3.

The nature of the relationship

11.45. Having set out the concerns of suppliers in some detail in the previous sections, we now examine the nature of the relationship between supplier and multiple and how it works in practice.

Buyers

11.46. The main parties almost invariably conduct their dealings with their suppliers at corporate or head office level; only rarely are store managers empowered to purchase locally. Suppliers deal directly with buyers specializing in particular products or product ranges. Buyers typically operate under a trading or senior manager and are the initial decision-takers in terms of both supply and price. Buyers are directly responsible for the commercial relationship with each supplier and generally have regular contact with principal suppliers on a daily or weekly basis. Continuity is an important element in maintaining a good multiple/supplier relationship. However, individual career development means that buyers are moved to different product ranges periodically, sometimes every 12 months.

11.47. Asda and Tesco told us that where buyers were given financial or other incentives over and above a salary, these were not related directly to their buying activities but involved participation in the relevant company profit-sharing scheme. Asda said that bonuses for its buyers were based on cash margins. Lower prices resulted in more customers which, in turn, resulted in higher sales. Sainsbury said that bonuses were linked to corporate profit before tax. Safeway said that it operated a cash and shares bonus scheme for senior buyers if certain sales and profit targets were met. It was similar to its corporate scheme.

Supplier lists

11.48. The terms ‘listing’ and ‘delisting’ (of product or of suppliers) are regularly used in the industry. The terms are somewhat ambiguous since, contrary to the suggestions of some suppliers, none of the main parties said that they maintained a list of suppliers, either formal or informal, such that appearing on it was a prerequisite of being able to supply. They maintained working lists of current suppliers; but most said that they were content to talk to, and to deal with, new or former suppliers. Likewise, the main parties said that, generally, they did not charge suppliers as a pre-condition for being on the multiple’s list of suppliers.

11.49. Suppliers used the terms ‘listing’ and ‘delisting’ to describe the decision by a main party to stock, or cease to stock, their products. In the case of a small supplier, which sells only a few lines in a single product category, delisting of its lines could also be said to result in the delisting of the supplier. Some of the larger suppliers suggested that some main parties, from time to time, had indicated that they were considering delisting product(s) in order to win an improvement in terms from the supplier. The improvement sought could be in an unrelated area.

11.50. Delisting was a principal concern of suppliers—even the largest. Frequently, manufacturers of branded goods said that they already had the widest possible distribution, and if a major product were delisted, they would be unable to find additional outlets. In addition, the main parties represented a high proportion of their sales. For many product lines, the main parties can instead sell a competing brand or their own brand.

11.51. One major supplier said:

> As the major multiple retailers now provide a significant proportion of available retail outlets and account for a high proportion of consumer sales, distribution of our products in these outlets is necessary for the success of our business strategy. The loss of access to a major multiple retailer would be very difficult, if not impossible, to replace and would have an impact on the successful implementation of our business strategy which … is crucially dependent on access to wide distribution. Increasing concentration of the UK retail environment, both through the reducing importance of the independent sector and through mergers of the multiples, increases this effect, as the lack of access to any given multiple retailer takes on increasing importance in the overall business.

11.52. Suppliers of short-life goods may be dependent on a few multiples. Many believed that the main parties were trying to reduce their supplier bases, a fact confirmed to us by some of the main parties. Manufacturers of retailers’ own-label products are, of course, totally dependent on the main parties for sales of those products.

11.53. The main parties gave several reasons for the discontinuation of product lines, including: lack of customer demand, manifested by low sales; inadequate quality; the identification of a substitute product or alternative supplier, giving improved value; product availability; health scares; EC policy influences; and the supplier's inability to meet recipe modifications for own-label products, for example the exclusion of genetically-modified ingredients.

11.54. Most of the main parties said that, for a variety of reasons, they had taken decisions during the past financial year to cease trading with some of their suppliers. The number of suppliers affected varied from multiple to multiple. Sainsbury had ceased trading with less than 100 suppliers and Safeway with 93 (Safeway added that this represented less than 5 per cent of the total and might include changes of name, merger or consolidation within its supply base). At the other end of the scale, Booth had ceased trading with four and Budgens with seven suppliers. Tesco told us that, whilst it had ceased trading with 63 suppliers in the last financial year, it had begun trading with about 300 in the same period. Some main parties added that these numbers were generally in line with those in the previous five years.

11.55. Responses by the main parties suggested that the amount of lead-time or notice given to suppliers when introducing or discontinuing a product line varied widely. One had a published system of lead-times for launching a product into its stores, typically three to four weeks for fresh food and eight weeks for ambient products. Other respondents suggested periods of up to six months, and similar periods were reported for discontinued lines and major marketing programmes.

Contractual arrangements

11.56. Full written agreements between the main parties and their suppliers are unusual. Day-to-day negotiations (particularly on price and quantity) are usually conducted orally. Some of the larger main parties told us that full written agreements were not generally applicable in this industry; the large numbers made detailed individual legal contracts impractical. Tesco said that supermarket retailing was characterized by highly efficient and developed channels that, in turn, necessitated a certain kind of contractual relationship between retailers and suppliers. With computerized sales-based ordering and EDI, the relationship with suppliers was about a constant series of interactions, with volumes and delivery dates being confirmed electronically. Safeway did not accept any adverse effects arising from its conduct towards suppliers but acknowledged that there were concerns, especially among smaller suppliers, regarding their relationships with multiple grocers. For some of the main parties, standard terms and conditions, covering routine legal issues such as insurance, title to goods and risk, were in place but specific terms for individual suppliers, which depended on the nature of the product, covering quality, volume, specification, delivery date or price were often oral. Suppliers supported these statements and suggested that moving towards written contracts might assist them.

11.57. One large supplier summarized the contractual situation as follows:

> The vast majority of sales are made to multiples under informal contracts where only the price, time of delivery and order specification are readily identifiable terms and conditions agreed between the parties. Products are supplied subject to day to day orders. Invariably, in the case of both branded and own-label product supply, standard terms of each party are exchanged during the course of trading, but a battle of forms effectively exists with neither party formally agreeing a particular set of contract terms. On occasions, retailers circulate their standard terms and conditions for signature by suppliers but suppliers generally raise amendments and no agreement is concluded. Matters such as credit terms and promotional activity are often agreed orally between retailer and supplier. Where issues arise between retailers and suppliers, or the retailer requires an amendment to the specification or an order (other than the specified price, delivery time etc), such matters are settled in the course of day to day business relations between the parties.

11.58. Contracts tend to be open-ended or ongoing and there is no standard length to them. Four weeks' notice is normal to terminate the arrangements, although longer periods of between three and eight months for dairy produce are given; for retailer's own-label products, three months is not uncommon. For fresh produce suppliers, agreements on price are usually on a week-to-week basis. Generally, the size of supplier does not influence the amount of notice required. Notice periods from suppliers are uncommon.

11.59. We asked larger suppliers how satisfied they were with their contractual arrangements (as opposed to their general relationship) with retailers. Less than 20 per cent were prepared to comment on individual main parties, the remainder commenting generically. Hence a detailed analysis by each main party was not feasible. Overall, larger suppliers graded 2 per cent of their contractual arrangements with the main parties as 'excellent'; 34 per cent as 'good'; 54 per cent as 'acceptable'; and 10 per cent as 'fairly poor'. There were some variations between categories of supplier. For example, the alcoholic beverage suppliers graded 54 per cent as 'acceptable' and 46 per cent as 'fairly poor', while the chilled/frozen food suppliers graded 2 per cent as 'excellent', 23 per cent as 'good', 74 per cent as 'acceptable' and 2 per cent as 'fairly poor'.

Retailers' own-label suppliers

11.60. The main parties' relationships with their suppliers of own-label groceries appear rather different in several important respects from relationships with suppliers of branded goods. The commissioning multiple is given universal access to the manufacturing processes involved, and main parties told us that they needed to keep a degree of control over quality assurance since their reputations were at stake (see paragraph 11.119). Own-label manufacturers are either required or encouraged to innovate and to develop existing products, frequently in conjunction with the multiples themselves. Intellectual property rights vary according to the source of the new product. In general, ownership appears to depend on the source of the innovation, and might cover only aspects of the product such as artwork or packaging, in particular where own-label goods with copyright logos or trademarks have been involved. However, one supplier of retailers' own-label products suggested that it had spent expensive specialist time developing product formulations but that obtaining formal recognition of this was difficult and confirmation of formulation ownership in such circumstances was rarely achieved. It was concerned that formulations which it had developed had been subsequently given to others who might then offer them in direct competition.

11.61. Some suppliers suggested that the main parties used branded manufacturers, both large and small, as a source of innovation and ideas for new products which they then copied. They said that new ideas were given trial listings, normally in a few stores. If a trial were successful, some multiples would launch their own-label imitation of the product, often using almost identical packaging and recipes. This inevitably resulted in lost sales for the original brand, the suppliers said, at worst resulting in delisting.

11.62. Main parties generally insist on exclusivity of supply for their own-label products (that is, that they should not be supplied to other retailers in different packaging). Some of the major own-label producers supply very similar products to different retailers. Such a requirement was exceptional for suppliers of unbranded goods. The volume of a particular product required will sometimes mean that a supplier is unable to supply more than one main party at any given time.

11.63. Some main parties told us that it would be possible to change the source of supply of their retailers' own-label products, but the long-term nature of such relationships and the potential costs involved in, for example, technical approval, packaging design and clerical processing would discourage change. Conversely, some main parties said that changing suppliers of unbranded, particularly commodity, products would be relatively easy.

Efficient consumer response and category management

11.64. A major development currently under way in supplier/retailer relationships is ECR. This is a process whereby suppliers and retailers work together in order to reduce inefficiencies in the supply chain, particularly in logistics. The emphasis is on determining consumer needs and reacting to them, rather than persuading consumers to buy what is available.

11.65. ECR was developed in the USA and is more established there, but has received growing acceptance in Europe. ECR Europe is a forum for retailers and suppliers across Europe who are involved in ECR. It has identified three key aspects of ECR:

(a) *Demand management*, where categories of goods are defined consistently by retailers and suppliers, and both jointly manage product categories as business units, coordinating promotions, ranges and product introduction.

(b) *Supply management*, which involves integrated systems to facilitate the scheduling of production, continuous replenishment (minimal inventories) and automated store ordering.

(c) *Enabling technologies*, which is the use of systems such as EDI and electronic funds transfer to support the integration and coordination implied in the two above.

ECR Europe summarized the objectives of ECR as 'working together to fulfil consumer wishes better, faster and at less cost'.[1] Large benefits are claimed for ECR. Further information is given in Appendix 11.4.

11.66. ECR has not been universally adopted by the main parties, although several of them said that they subscribed to its general principles. Asda said that ECR was, essentially, delivery of consumer satisfaction and enhancing of business performance. Key elements were an understanding of, and response to, consumer demand, together with efficient operation and collaborative working through the supply chain. Tesco told us that it applied basic ECR principles across the whole of its supply base. It had attempted to design systems with low IT investment needs so that they could be extended to all suppliers, and to make entry to EDI as easy as possible for suppliers of all sizes. For Tesco, ECR was the basic building block to be applied to supplier relationships across the scale. Sainsbury said that it had been able to implement ECR ideas to increase efficiency. Safeway said that it used predicted consumer demand as the main driver of its sales-based ordering system. A supplier information system was one example of how it had jointly improved retailer/supplier communications. It added that the commissioning of its three UK price consolidation centres had improved the efficiency of the produce supply chain.

11.67. The supply management and IT aspects of ECR are relatively uncontroversial (see Chapter 10). In this section, we concentrate on demand management and, in particular, its central activity, which is category management.

11.68. The IGD defined category management as 'the strategic management of product groups through trade partnerships, which aims to maximize sales and profits by satisfying consumer needs'. These principles can be applied in a variety of ways, and the IGD noted that each retailer adopting category management had developed its own unique approach. ECR Europe's definition is 'category management is a retailer/supplier process of managing categories as strategic business units, producing enhanced business results by focusing on delivering consumer value'. A category is 'a group of products that satisfy a consumer need. Products may be grouped into categories on a purely product based approach or on the basis of where they are consumed or occasions on which they are purchased'.[2]

11.69. In broad terms, category management entails a leading supplier being responsible for analysing data on consumer preferences; identifying the best means of meeting these; determining the most effective ways in which suppliers can provide the relevant products, in terms of range and allocation of space; and advising the retailer accordingly.

11.70. The ultimate extension of category management is for one manufacturer to be a category 'captain' and take on the organization of the category itself. For example, we heard that, in the USA, the account managers of Wal-Mart's leading suppliers worked full time at the retailer's offices. These account managers helped manage the category.[3] This has problems, though, since determining the optimal profitability of the category for a retailer involves assessing the profitability of each line stocked and might result in removal of some of the category captain's own brands or products. This could generate conflicts of interest and requires, therefore, a considerable degree of honesty and objectivity from the category captain.

11.71. Concern has been expressed that category management, whilst reducing costs and improving efficiency, is not without a (potential) cost to competition. The European Commission noted[4] that

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[1]Quoted in *Category Management in Action*, IGD, 1999.
[2]See footnote to paragraph 11.65.
[3]See footnote to paragraph 11.65.
[4]*Green Paper on Vertical Restraints in EC Competition Policy*, 1997.

modern distribution techniques tended to consolidate the national delineation of markets, as increased co-operation between suppliers, distributors and retailers in a country, through the use of information technology and a close coordination of logistics, led to a greater investment in the relationship between the parties. Hence, it could act as a barrier to entry for new, particularly foreign suppliers. In addition, it said that modern distribution techniques tended to consolidate the position of the number one and two brands in the market, where less strong brands were delisted and replaced by the retailer's own-label goods.

11.72. Many larger suppliers were involved in category management (almost 80 per cent of the respondents to our LSQ had experience of it), although many stressed that at most they were category advisers, not managers. Some were enthusiastic, and a number attributed improvements in their relationship with the main parties to (joint) participation in category management projects. Some suppliers said that they would always prefer to be selected for a project, rather than have a competing supplier selected, despite the additional resource cost and effort involved.

11.73. Some suppliers raised concerns about category management. First, participation in category management may give privileged access to sales data to one supplier, compared with its competitors. Second, only the very largest suppliers would have sufficient resources to participate in projects simultaneously with all their major customers, giving them a potentially significant advantage. Some smaller suppliers were concerned that category management, and consequent consolidation practices by the main parties, were reasons for losing business, and could also act as a barrier to entry, especially for secondary and tertiary brands. A trade association commented that when a category manager was appointed, this was predictably the brand leader in that category. It added, 'This mitigates heavily against smaller suppliers and the strong regional brands as unfair priority is given to new entrants to the market, with regionality being streamed out'. A number of smaller suppliers believed that category management favoured larger suppliers. One said: 'Category management will normally favour the larger, often multinational, companies and brands due to their greater resources and negotiating strength'. Another said: 'The UK brand leader in cakes is allowed to control the cake section'. A third referred to the 'delisting' of some products as multiples moved all similar lines to a category manager, and a fourth said: '… category management benefits the larger supplier who specifically dominates the category at the expense of smaller suppliers'.

11.74. Some suppliers took a cynical view of their customers' motives in adopting category management. In the IGD Category Management Survey, supplier comments included: 'Realistically, Tesco, [Sainsbury] and Safeway fully embrace it—most other retailers are using the "badges" of category management but not the workings' and 'One or two are very good, the rest think it is the latest "buzz"'.

11.75. For the future, many saw category management remaining central. For example, respondents to the IGD survey said: 'Category management will become the underlying process to the way companies conduct business', and 'Category management will be the only way to work with major trading partners and to shape/influence the future for the category to the benefit of the consumer'.

The policies of the main parties on treatment of suppliers

11.76. Tesco sent us a copy of a brief guide, designed to assist buyers in avoiding problems with suppliers. It provided a checklist to be used when, for example, taking on or terminating business with suppliers and advised on difficult supplier situations. The guide identified certain cases, such as small or seasonal suppliers and those which had considerable reliance on Tesco, which had a greater sensitivity and needed to be handled with care. The guide said that in such cases buyers were required to ensure that contract terms were understood by suppliers and that care was taken in what was said to them, since this might become part of the contract. The guide made it clear that there would be regular reviews of performance; that buyers should respond promptly in writing to correspondence which might affect original contract terms; confirm all important decisions in writing in advance; and keep a record of communications. Guidance was given also on situations in which relationships with suppliers might be terminated and on alternatives to termination.

11.77. Asda said that it prided itself on its good relationships with suppliers. It referred to its *Stress Buster* booklet which was sent to all suppliers and which set out how Asda expected its relationships with suppliers to function. Asda said that, to some extent, it operated a voluntary code of conduct of which its suppliers were aware. Sainsbury told us that it was producing an internal code, or manual, for buyers and that it was formalizing a process through which suppliers might lodge appeals. The manual, which was finalized by the end of our inquiry, sets out Sainbury's view on key stages in the supplier relationship. These include responsibilities for selecting suppliers, trading terms and conditions, communications, guidance on company policy on such matters as listing fees, discounts and supplier refunds, supplier funding on promotions, third party involvement and problem resolution.

Alleged barriers to new suppliers

11.78. As part of their quest to satisfy customers, some of the main parties placed considerable demands on their suppliers. For example, the ability to achieve the required product quality, and a capacity or potential for supply in volume, are essential prerequisites. There may also be difficulties with incompatible IT systems, creditworthiness, product development or innovation. As noted in paragraph 11.71, aspects of category management may act as barriers to entry.

11.79. One-third of the smaller suppliers which responded to our questionnaire said that barriers to entry did exist, and just over one-quarter said that they had been affected adversely by them.

11.80. Larger suppliers gave varied and contrasting views about their particular product areas. Only one-quarter indicated that there were no barriers to entry in their area. However, many responses were qualified in accompanying text. One fairly common view was that although none of the potential barriers we identified represented an insurmountable hurdle on its own, in practice a combination of hurdles would be very demanding for a new entrant. Some respondents commented that retailers were willing to listen to convincing rationales for innovative products, but examples of new product entries quoted tended to be either from large companies (for example, Sunny Delight) or niche products (for example, 'fair trade' beverages).

Internationalization

11.81. A further trend worthy of note is the growing internationalization of the main parties. Several large suppliers said that main parties were seeking to negotiate at an international (for example, Europe-wide) level, rather than negotiate separately in each national market.

11.82. One supplier told us that it was now in negotiations with the Wal-Mart/Asda group for the supply of own-label products. It believed that, as the interests of retailers became ever more global, they would increasingly demand global supply contracts. Another said that internationalization would inevitably lead to formalization and standardization of trading relationships, and increased negotiating power for the larger retailing blocks.

Pricing and discounts

11.83. Complaints by suppliers, especially those supplying fresh produce, meat products, dairy and bakery products, included the low (in their view unreasonably low) prices for their goods. Some suppliers suggested that unnecessarily low prices were exacerbated by the imposition of new procedures or regulations whereby the main parties improved their own efficiency but at the supplier's cost. Many complained that they were forced to participate in the multiples' promotions of a particular line, under the threat of delisting. This meant selling at a lower price and might even result in their selling at a loss.

11.84. 80 per cent of smaller suppliers told us that there were differences in the prices they obtained from different retailers. Some suppliers indicated that they published price lists covering their major business with main parties but, where these lists existed, the major parties frequently negotiated substantial across-the-board discounts.

11.85. 66 per cent of smaller suppliers said that the prices they obtained for their goods from the main parties were at least adequate for them to maintain their business. 25 per cent said that they allowed little more than break-even and 5 per cent (17 respondents in total) said that it was difficult to maintain business. Of the 17, 14 supplied foods and 3 other goods, but the 14 were spread over a number of different categories of food.

Price negotiations

11.86. In paragraphs 11.24 to 11.26 we set out some of the concerns of suppliers about the way price negotiations with main parties were conducted. We also asked the main parties how they viewed these negotiations and whether negotiating strategy differed depending on the type of supplier. We were told that generally price negotiations did not depend on the type of supplier, but on the product. The prices for perishable goods tended to be influenced by market fluctuations and negotiations took place, for the most part, on a weekly basis, whereas negotiations were less frequent for 'must stock' items where manufacturers had standard price lists. Asda said that there were quoted market values for fresh meat and that prices were determined by basic market forces. It said that there were market prices also for produce but these were driven more by global than national factors. However, the type of supplier also appeared to be significant. Sainsbury said that some multinationals insisted on limiting negotiations to discount levels and the extent of support to be given for promotions. Tesco told us that, with powerful branded suppliers, cost price negotiations would be driven by the fact that the supplier knew that retailers must stock the product in question, and it was not viable to push negotiations to a point where it might be left without the product; this would lead to customers shopping at other stores. It added that on such occasions suppliers tended to show little, if any, flexibility on prices. In many cases, suppliers would simply present a list of the new cost price with limited, if any, justification for increases. Tesco sought to obtain justification for cost increases from all suppliers, but major brand owners tended to respond with differing levels of detail or none at all. Tesco said that, with secondary/tertiary and own-label suppliers, retailers would generally have more constructive discussions around cost prices.

11.87. The factors which some main parties saw as justifying paying lower prices to suppliers included: increased volume; changes in suppliers' costs, currency exchange rate movements, and products under-performing; and the identification of alternative sources of supply. The most common reasons for suppliers to seek higher prices were changes in raw materials costs, increasing supply costs and exchange rate movements.

Discounts

11.88. Suppliers offered, and larger main parties sought, discounts as a normal feature of negotiations. Discounts, whether requested or offered, were usually volume or promotion related. Many suppliers complained of discounts being sought, or even imposed, retrospectively.

11.89. Some suppliers said that the main parties used their negotiating strength to seek further discounts or payments, including guaranteed and/or incentive discounts and overriders (discounts based on sales volume and paid retrospectively by the supplier to the retailer), and that some main parties often sought payment of incentive discounts even when they failed to achieve the target threshold. They might also seek annual or quarterly payments for agreeing to annual promotion plans, listing fees, and contributions towards the opening or refurbishment of stores.

11.90. The main parties varied in their approach to retrospective discounts. They were described by one as a function of an established, ongoing and cooperative relationship, providing a mutual incentive for both retailer and supplier to grow the business. Another said that suppliers used them as long-term incentives to achieve negotiated targets. Some of the main parties, however, said that either there was no role for retrospective discounts in their dealings with suppliers or that the role was limited, for example, to promotional activities (see Appendix 11.3).

11.91. Suppliers frequently offered concessions on unit prices to the main parties, designed to ensure, among other things, that currently stocked items continued to be listed. These typically took the form of discounts, or promotional offers. Concessions were also given in order to secure an improvement in the range and depth of distribution within the supermarket and to ensure that new product lines were stocked. Suppliers of major branded goods placed a high priority on having good-quality shelf allocation and fair access to promotional slots, relative to the retailer's own and competitors' brands. Some suppliers offered rebates for prompt payments and for compliance with certain logistical factors, such as full pallets or lorry loads, and EDI ordering.

11.92. Margin support payments are sometimes requested by the main parties or negotiated between multiple and supplier, typically to mitigate erosion of a multiple's gross margin when retail prices are reduced. Some of the main parties suggested that such payments might be made following a period of promotional activity. Safeway, for example, said that it might attempt to renegotiate cost prices when retail selling prices were significantly reduced in the market place. Although it would seek to share the cost of margin erosion, any supplier contribution which might be made was part of normal commercial negotiations with suppliers. Somerfield said that it frequently asked for margin support either to improve its terms or to prevent the loss of profit as a result of competitive retail pressures. It said that this would be in the context of products having to justify their return on space as well as meeting the needs of the consumer. Asda said that, although it was moving away from promotions as a marketing tool, it was frequently offered, and received, margin support from suppliers for them.

11.93. Some main parties said that suppliers would usually contribute towards promotions of their products, after negotiations; many suppliers said that effectively they had no choice if they wished to continue to supply. Levels of contribution varied. Where we were given figures, typically between 40 and 60 per cent of the retail price reduction was borne by the supplier rather than the retailer, although on occasion either the main party or the supplier might fund the total cost of the promotion. None of the main parties said that they made contributions to suppliers' expenditure on promotions.

Payments by suppliers to the main parties

11.94. Some of the main parties acknowledged the use of clauses which required the payment of compensation in their agreements with suppliers; the clauses took account of losses incurred through, for example, incorrect bar coding, late deliveries, incorrect delivery documentation, poor pallet stacking and product withdrawal. Others did not make use of such clauses. Some main parties said that they had imposed specific charges, depending on the supplier's alleged shortcomings; others had sought to cover loss of sales and profit, plus communications and administrative costs.

11.95. Most of the main parties told us that suppliers often sought, and reached, agreement with them on the use of display areas, such as gondola ends, to promote products and that the suppliers might offer or negotiate special payments for the privilege. One main party said that it had invited suppliers to bid for such display of their products. Some suppliers were said to have required at least partial exclusivity in respect of freezer or chiller space.

11.96. Some main parties said that they charged for stocking and displaying a supplier's products (listing fees). However, these were mainly in connection with the introduction of new lines, where charges would be made to offset the administrative costs concerned with promotional programmes, use of in-store point-of-sale material and clearing delisted lines. Such charges spread the risk associated with new products, and without them some main parties said that the risk involved in many launches would be too high. Some suppliers said that they regarded these charges as exploitation of the power differences between the retailer and the supplier.

11.97. As noted in paragraph 11.27, some suppliers reported ad hoc demands for additional payments, often on grounds which the supplier regarded as spurious.

Credit terms

11.98. There was considerable variation in the credit terms received by the main parties, with periods ranging from seven days to more than 60. A number of suppliers suggested that credit periods had become established by custom and practice and then were difficult to change. There was no clear relationship between credit length and supplier size. While none of the main parties provided direct financial support to suppliers as a matter of course, most said that they would offer to pay more quickly, if requested, to assist with a supplier's short-term cash-flow problems. On the other hand, some of the larger suppliers appeared to receive much poorer terms. Credit terms, as measured by number of days' sales, appear not to have increased since 1993, with the exception of Morrison (see paragraphs 8.92 and 8.93).

Below-cost selling

11.99. Below-cost selling was of concern to a number of suppliers. They said that it could distort the price structure of whole categories, and hence the mix of products bought, and that it put enormous pressure on manufacturers to reduce prices to offset retailers' losses as consumers switched to products sold below cost. One supplier said: 'The retailers can absorb the losses because of sales mix, many manufacturers cannot.'

11.100. We were told that, for baked beans, cheapest on display products were originally sold at 16p to 19p and accounted for 13 per cent of the market. The price subsequently fell to 9p and sales then accounted for 37 per cent of volume. We were told that during the so-called 'baked bean wars' period, prices fell to 3p–5p per can. Nestlé said: '… we literally could not can fresh air for the price they wanted to retail it at … the cans were costing us more than [that]'. Nestlé closed its Crosse & Blackwell canning operations and withdrew from that area of business.

11.101. The effects of below-cost selling in the UK vegetable canning industry were exacerbated by adverse exchange rates. In addition, we were informed that some overseas companies were willing to trade at prices below normally commercially viable levels in an effort to fill spare capacity. We noted that as well as Nestlé closing its UK canning operations in 1998, another supplier imported all its canned vegetables. Bakeries were concerned about the use of the standard sliced white loaf as a loss leader by multiples, creating a belief among customers that other types of bread were overpriced.

Relationship between buyer size and supplier margins and prices

11.102. The net effect of the payment of fees, discounts and various offers is, not surprisingly, that some main parties pay less than others for their supplies. We examined information from larger suppliers to see whether there was any statistical evidence that certain main parties had greater buying power than others.

11.103. Analysis at a product level is problematic because of factors such as: differences in promotional activity by main parties; that they take different mixes of pack sizes purchased; or main parties negotiating a 'good' price on one product/pack size, but perhaps accepting a relatively 'poor' price on another.

11.104. We examined the effects of buyer power in three ways:

(a) the difference in gross margins which suppliers obtained overall from different main parties;

(b) for individual large suppliers, the relationship between gross margin and volume of sales for the main parties supplied; and

(c) the difference in the product prices paid by individual main parties for suppliers' top five product lines, aggregated over a range of suppliers.

All the larger main parties should be able to take advantage of most of the cost savings associated with buying in large volumes, so significant differences in margins and prices are more likely to reflect the strength of the buyer than lower costs. Fuller information on the approach we took is given in Appendix 11.5; our results are summarized below.

Aggregated gross margin analysis

11.105. We first compared the percentage gross margins obtained by suppliers from individual main parties with the sales-weighted average percentage gross margin obtained by the supplier from all sales to main parties. Then, for each main party the appropriate margin differences were averaged over all suppliers. The analysis was restricted to 19 large suppliers selling predominantly branded goods, in order to avoid distortions caused by differing ratios of branded to retailers' own-label sales. Most suppliers had aggregated data for individual Co-ops within their appropriate buying groups (see Appendix 11.5 for further details). The average differences (from individual suppliers' average gross margins) for several main parties are shown in Table 11.7.

11.106. Overall, suppliers achieved the lowest gross margin from Iceland, which told us that it was a 'promotionally driven company'—concentrating on promotions offered by suppliers and not necessarily carrying the full range. The next lowest margins were from Sainsbury and Tesco (the difference between them was not statistically significant). Somerfield gave the next lowest margin; several large suppliers told us that Somerfield had used its merger with Kwik Save as an opportunity to negotiate better terms.

TABLE 11.7 **Differences in gross margin obtained from different main parties by a sample of large suppliers**

Main party	*Suppliers in sample*	*Average difference %*
Iceland	14	
Sainsbury	19	
Tesco	19	
Somerfield	19	
Netto	9	
Asda	19	✂
Safeway	19	
Morrison*	18	
Budgens	13	
Booth	12	
Waitrose	18	

Source: CC analysis of supplier information.

*Morrison is a minor customer of one large supplier; we excluded this. Including this supplier would increase Morrison's difference to +2.25 per cent.

Notes:

1. Co-op buying arrangements were changing during the period in question. Also Co-ops have been aggregated in different ways in supplier data, with some suppliers giving individual data for the largest Co-ops. The average Co-op difference was about +2.8 per cent, with a range from +2.4 to +3.3 per cent for various combinations of Co-ops.
2. Budgens and Booth are members of the Nisa buying group, although most suppliers provided separate data for them.
3. Aldi, Lidl and M&S do not stock manufacturers' brands, so are excluded from the table.

11.107. Apart from Iceland and Netto, suppliers obtained the lowest margin from the major buyers and the highest gross margins on sales to the smaller retailers. Netto purchased groceries from only 9 of the 19 suppliers. One supplier said that the relatively low margin it received from Netto was because it was a 'limited range discounter, stocking a pack mix of secondary brands, affecting the overall business mix. This retailer may also purchase residual end of line products'. As well as stocking a limited range, it is possible that Netto had introductory offers from a few suppliers seeking to win business from it.

11.108. The relation between the actual price paid by a main party and the supplier's gross margin is non-linear (see Appendix 11.5). The average gross margin for the suppliers in our sample was 35.83 per cent. For a hypothetical average supplier selling items costing it £1 each, the prices paid by the main parties would range between £1.52 and £1.66 respectively per item. The figures for a number of main parties are shown in Table 11.8. On this basis, the main party paying the highest price would pay 8.8 per cent more than the main party paying the lowest price.

TABLE 11.8 **Prices paid by the major buyers for an item costing a supplier £1**

Main party	*Supplier's price for item cost of £1*	*Premium on Sainsbury price %*
Iceland		
Sainsbury		
Tesco		
Somerfield		
Netto	*Figures omitted. See note on page iv*	
Asda		
Safeway		
Morrison		
Budgens		
Booth		
Waitrose		

Source: CC analysis of supplier information.

11.109. The suppliers we analysed included some of the most powerful suppliers, with strong brands and no reliance on retailers' own-label sales, and therefore those most able to resist any buyer power. Many of the main parties are large enough to achieve most of the cost savings associated with central warehouses and larger orders (full lorry loads and so on), so cost savings are unlikely to account for the observed differences. It should be noted that smaller retailers will have more market power vis-à-vis medium-sized suppliers and suppliers of commodity and own-label products than the large branded suppliers included in the above analysis. In our examination of the prices and margins of (generally small) fresh produce suppliers (see paragraphs 11.158 to 11.161) we did not find wide differences in price.

Individual gross margin analysis

11.110. The analysis above indicated in a general way that even very large suppliers accept lower margins from the major buyers. We examined this question in more detail by quantifying the relationship between the gross margins and sales volumes for the main parties for each of 32 large suppliers individually. We did this by fitting regression models for each supplier.

11.111. The difference in suppliers' gross margins between branded and retailers' own-label products has an impact on the results. Where suppliers sold little or no retailers' own-label products, there was a clear relationship, with gross margin falling as sales increased for most suppliers. Generally, where suppliers had substantial own-label sales there appeared to be no statistically significant relationship, probably owing to different mixes of branded and own-label products for different customers. The results are discussed in more detail in Appendix 11.5.

11.112. Overall, at least for branded goods, there appears to be a significant relationship between margin and sales in many cases. The analysis of the gross margin data for individual suppliers is consistent with the other analyses and the comments of suppliers.

Top five line prices

11.113. We analysed the prices paid for 26 large suppliers' top five branded lines in a similar way to the gross margin analysis and with similar results. Again, the analysis is discussed in more detail in Appendix 11.5.

11.114. Multiples pay on average between 3.8 per cent less and 4.7 per cent more than the average main party price (net of all discounts), with the retailer paying the highest price paying 8.8 per cent more than the one paying the least. The larger main parties, on the whole, pay less than small ones, with Tesco, Sainsbury, Asda, Somerfield and Safeway paying the lowest prices. The results are given in Table 11.9. The figure for Iceland was higher than average, at 101.0 per cent, consistent with the view that it concentrates on promotions rather than carrying a full range. The figure for Netto is also consistent with it being an outlier in the aggregated gross margin analysis.

TABLE 11.9 **Suppliers' top five lines: main parties' price paid relative to unweighted average of main parties**

	Lines	*% of average*	*Standard deviation %*	*% of lines for which prices paid are less than average*
Tesco	126	96.2	6.5	80
Sainsbury	125	97.7	8.4	74
Asda	127	97.8	7.4	66
Somerfield	130	98.4	5.8	65
Safeway	123	98.8	5.7	65
Morrison	122	99.8	7.3	46
Iceland	66	101.0	10.9	38
Budgens	85	103.6	7.3	24
Netto	24	104.2	7.5	21
Waitrose	103	104.4	9.2	23
Booth	74	104.7	9.3	26

Source: CC analysis of supplier information.

Notes:

1. Analysis based on top five branded product lines for 26 suppliers.
2. The average price is averaged over all parties and is not weighted by turnover.
3. Standard deviation influenced by outliers, eg Sainsbury standard deviation would reduce to 5.5 per cent, if two lines discounted. Sainsbury appeared to be the only main party promoting one line and not promoting the other.
4. Aldi, Lidl and M&S do not stock manufacturers' brands, so are excluded from the table.
5. Suppliers aggregated Co-op data in different ways. The average price, averaged over the different Co-op groupings, was about 100.5 per cent, with a range of 99.6 to 101.5 per cent.

11.115. Table 11.10 shows the same data analysed relative to Tesco, which paid the lowest price in this analysis.

TABLE 11.10 **Suppliers' top five lines: main parties' price paid relative to Tesco's price**

	Lines	*% of average*	*Standard deviation*	*% of lines for which prices paid are less than Tesco*
Tesco	126	100.0		
Sainsbury	122	101.6	10.0	48
Asda	124	102.3	10.2	32
Somerfield	125	103.0	8.9	31
Safeway	121	103.1	7.7	32
Morrison	118	104.6	10.2	20
Iceland	66	105.3	13.8	23
Waitrose	103	109.4	13.0	15
Booth	82	109.5	12.3	17
Netto	24	110.1	11.5	21
Budgens	70	111.1	14.4	14

Source: CC analysis of supplier information.

11.116. The gross margin analysis and the top five product lines analysis show similar differences between the five major buyers and the other main parties. The ranking of the five major buyers is not identical in the two analyses, but this may reflect different emphases on the prices of the top five lines within overall negotiations on terms. These differences appear greater than can be explained by any operating cost differences. Many of the top five lines appear to be KVIs, which may well have been on sale at similar prices in most supermarkets.

11.117. For comparison, Table 11.11 shows the relative prices paid by other types of retailer. It can be seen that all these categories of retailer paid much higher prices than the major buyers.

TABLE 11.11 **Suppliers' top five lines: prices paid by other retailers**

Retail category	*Number of lines*	*Price relative to average main party price %*	*Standard deviation %*
Warehouse clubs and wholesalers	114	108.7	11.0
Voluntary chains	114	105.4	8.6
Other retailers	96	103.7	11.3

Source: CC analysis of supplier information.

Product quality and innovation

11.118. The main parties reported broadly similar approaches to quality assurance and most said that it had remained broadly unchanged over the past five years, with the exception of third party accreditation. However, some said that systems had become more detailed and more structured. Requirements are usually very specific.

11.119. They told us that retailers' own-label goods were regularly checked for quality and safety, and to ensure that they conformed with agreed specifications (see paragraph 11.60). Similar principles operated for fruit, vegetables, dairy products, meat and other goods. Visits to suppliers' premises, to check that specified standards were being maintained, were frequently built into quality assurance processes. Some main parties made reference to legal obligations of due diligence, and some provided detailed descriptions of quality assurance schemes, procedures, codes of practice and guidelines.

11.120. Several suppliers raised concerns about the main parties' ability to ensure that overseas suppliers complied with the standards required of UK suppliers, particularly in those countries where legal and animal welfare standards and attitudes to enforcement of legal and other standards differed from the UK. We received many complaints in connection with pig-meat and fresh fruit among others. We discuss the issue of pig-meat in more detail in Appendix 11.6.

11.121. Suppliers and others were concerned about labelling which might give the impression that a product was of UK origin when it was not. In another example given to us, a local authority said it believed that a retailer which was selling 'English' butter had withdrawn it because of reported problems in Belgium over dioxin which implied that butter was being made in the UK with Belgian ingredients and then sold as English butter.

11.122. The main parties told us that all imported products met, at a minimum, UK quality and traceability standards. Some of them included overseas site visits as part of their 'due diligence' procedures. Safeway said that growing protocols established under the Assured Produce Scheme were fully implemented for both UK-sourced and, where applicable, overseas-sourced products. Where such protocols were not applicable due to differences in predominant pest/diseases or growing conditions, Safeway had been instrumental in establishing and developing a pan-European retailer group, EUREP, which was currently rolling out its GAP 2000 framework protocol and benchmarking system.

Supplier profitability

11.123. We examined the profitability of the main parties in Chapter 8. In paragraph 8.50, we noted that the 1999 average operating margin (operating profit as a percentage of sales) of 19 food producers and processors, most of whom are significant suppliers to the main parties, was 4.3 per cent, somewhat lower than for the main parties themselves. The RONOA of these companies was 18.1 per cent, slightly higher than for the main parties.

11.124. These 19 companies are all relatively large. The responses to the SSQ (see Appendix 11.2, Q3(iv)) suggested that a significant proportion of smaller suppliers are trading at very low operating margins. More than a quarter of those that answered this question were making operating margins of less than 2 per cent. On the other hand, some smaller suppliers were making very healthy margins.

11.125. While we did not carry out a detailed overall survey of suppliers' profitability, these results suggest that, in aggregate, suppliers are less profitable than their main party customers.

Behaviour of suppliers

11.126. In general, the main parties told us that suppliers had not imposed unrealistic restrictions on them. A few main parties referred to attempts by suppliers to impose recommended retail prices through price labelling, or to obtain price increases by threatening withdrawal of supplies. Others suggested one-off constraints. For example, the Co-ops said that, on a recent occasion, both major bread manufacturers had announced a price increase on the same day, thus restricting the retailer's ability to negotiate by playing one off against the other. However, most of the main parties said that they had not experienced any conditions on product resale being imposed by suppliers.

11.127. Most of the main parties said that they had not experienced suppliers refusing to trade with them or to give reasonable levels of credit, except that some suppliers would not manufacture retailers' own-label products. However, Asda provided examples where large multinational suppliers had threatened to withhold promotional support owing to their concern about Asda's EDLP policy. Asda added that, in one situation where it had reduced the price of the product, the supplier, in an attempt to reverse the price cut, indicated that it expected the rest of the market would soon be selling at the higher price.

11.128. Some main parties expressed concern that similar retailers in other EC member states received better terms from international suppliers. Safeway said that it had documentary evidence of differential pricing of branded products within the EC. Some multiples said that they had been refused direct supplies from overseas companies, including branches or subsidiaries of multinationals with supply bases in the UK. Asda said that there were many products which it could source more cheaply overseas but, in practice, this was nearly always unsuccessful. It said that suppliers referred to market conditions, exchange rates, different product ingredients and different packaging as reasons not to supply. Safeway said that, effectively, it was blocked from purchasing a branded product direct from the supplying group's lowest cost source in Europe because the local operation was not permitted to use the English language on packaging or export, or because product specification might be different. Somerfield also told us that major branded goods were often not available for purchase from overseas if the manufacturer had a UK sales operation.

11.129. We asked the larger suppliers to provide information on the prices they charged their customers in other EC member states. Specifically, we asked for prices as at the end of June 1998 for their top five branded product lines in the four largest multiple retailers' stores in each of the UK, France, Germany, the Netherlands and Italy. Details can be found in Appendix 11.7. Many of the larger suppliers did not export branded products; several of those who did had difficulty supplying data in our required format, and only limited data were obtained.

11.130. Direct price comparisons of suppliers' prices across Europe are very difficult. Few UK lines are also major lines in Europe and those that are often have different formulations. The analysis also highlighted some of the common problems in structuring an investigation of such price differences, in particular the choice of an appropriate exchange rate, and suggested that a 'shopping basket' approach may be preferable to a focus on individual branded products.

11.131. It is clear, however, that there are significant obstacles facing a UK retailer wishing to replace UK sourced branded goods with identical products sourced from overseas. The main obstacle is that strictly identical products appear rarely to exist.

11.132. In our suppliers questionnaires, we asked suppliers to what extent they had, in the previous three years, engaged in behaviour towards the main parties (intentionally or otherwise), which might have been regarded by retailers as unreasonable. Their responses reflected occasional problems with production, with more than one-half saying that sometimes they had not delivered the agreed quantity. In some instances suppliers argued that this was influenced by unreliable promotional forecasts by certain main parties.

Proposed code of practice

11.133. We were told that a code of practice to regulate relations in the food industry was being developed, under the auspices of MAFF and facilitated by the IGD, by Asda, Morrison, Safeway, Sainsbury, Somerfield and Tesco. The IGD told us that the code exemplified best practice in commercial relationships with trading partners. It added that the code, which was not intended to be overly burdensome or bureaucratic, recognized the responsibility of all members of the food chain to each other and collectively to the consumer. The IGD said that underpinning the code were three principles:

(a) It was important for retailers, caterers, wholesalers, manufacturers, primary producers and those involved in consumer goods generally to recognize the competitive pressures of the market place and the need to respond quickly to customers to deliver value.

(b) All supply chain participants, in whatever sector, would benefit if they worked together to expand the market for their products and develop a profitable and sustainable business.

(c) All trading partners should be treated fairly and reasonably.

11.134. In a properly functioning market, competition should ensure that suppliers:

(a) have a reasonable degree of certainty as to the price they will receive (or the factors which can subsequently alter the price) when they accept orders;

(b) not be required to vary the terms on which they are trading with multiples without reasonable notice (though the latter is likely to depend heavily on the nature of the products concerned); and

(c) not face unreasonable or discriminatory trading terms or conditions.

We suggested to the main parties that, if excessive buyer power was inhibiting the proper functioning of this market, then a remedy would be required.

11.135. One remedy would be the adoption of a Code of Practice, which might seek to cover some or all of the following:

(a) requiring reasonable notice of (i) any variation in the terms and conditions of supply (this to cover both standard terms and conditions of business and the terms of individual contracts, whether written or oral) and (ii) of any requirement or invitation to contribute to the cost of promotions;

(b) requiring reimbursement of costs imposed on suppliers as a result of variations of the terms of supply by supermarket operators for which reasonable notice is not given;

(c) prohibiting discrimination against suppliers because they are not prepared to participate in or contribute to certain promotions;

(d) prohibition on operators requesting or insisting that suppliers give them discounts from previously agreed prices other than where the basis for this has been identified and agreed in advance;

(e) prohibition on any penalty charges, fines or additional discounts for failure by suppliers to meet quality specifications, delivery quantity or times etc where the method of determining the payment is not agreed in writing in advance;

(f) prohibition of any discrimination in the quality standards required as between one supplier and another for the same product;

(g) no financial contributions to any third parties to be required or invited;

(h) exclusive supply arrangements to contain identifiable benefits for suppliers to compensate for the restriction on their trading, and reasonable termination notice given to reflect this restriction;

(i) agreeing with suppliers at the outset of a contractual relationship whether the cost of supplier audits by supermarket operators are to be paid by the supplier, and means for ensuring that such costs are not excessive;

(j) no supplier to be given control of access to, or management of, operators' shelves;

(k) listing fees, shelf access fees or other non-performance-related fees, or more generally fees payable as a condition for stocking, ordering or displaying products to be prohibited. Alternatively any such fees to be chargeable only where the operator subsequently guarantees to take a reasonable minimum supply of products. In the case of listing fees these might be required not to exceed the identifiable cost of assessing a supplier's suitability;

(l) no interference with suppliers' other business activities, including prices charged by suppliers to other retailers;

(m) all arrangements with third parties involved in the supply of complementary goods or services, for example packaging or transport, to be transparent and agreed with the product supplier at the outset, in particular including any charges made by operators to third parties which the latter might seek to reclaim from the supplier; and

(n) prohibition of credit terms beyond a specific limit, for example 30 days, or, alternatively, prohibition of credit terms which unreasonably discriminate between suppliers, or both.

11.136. We asked the main parties for their views on such a Code, and whether it should be voluntary or not. Their views are set out in Chapter 14.

Supply chain issues

11.137. Retailing is the final stage of bringing goods to consumers. At the time of the reference, the DGFT expressed concern over the impact that main party practices might have throughout the supply chain, particularly for agricultural produce such as beef. In this section, we examine in greater detail issues related to the supply of those goods where particular concerns had been expressed.

11.138. The supply chain for food is shown schematically in Figure 11.1. This shows the relative scale of the various parts of the food chain. MAFF told us that total purchases by farmers (including compensation to employees, interest and net rent) in 1997 was £12.5 billion and that sales to the food distribution chain (wholesalers, retailers and caterers) was of the order of £58 million.

Food Chain Group

11.139. In January 1999, the Minister for Agriculture, Fisheries and Food set up the Food Chain Group to review opportunities for working together and increasing understanding among the players in the food chain and between the industry and consumers in England. Membership comprised senior representatives from the British Retail Consortium, Food and Drink Federation, the IGD, the National Farmers' Union and MAFF. It reported in November 1999, recommending action by both business and government in a number of areas:

(a) an enhanced constructive dialogue between the partners in the food chain;

(b) improved communication with consumers;

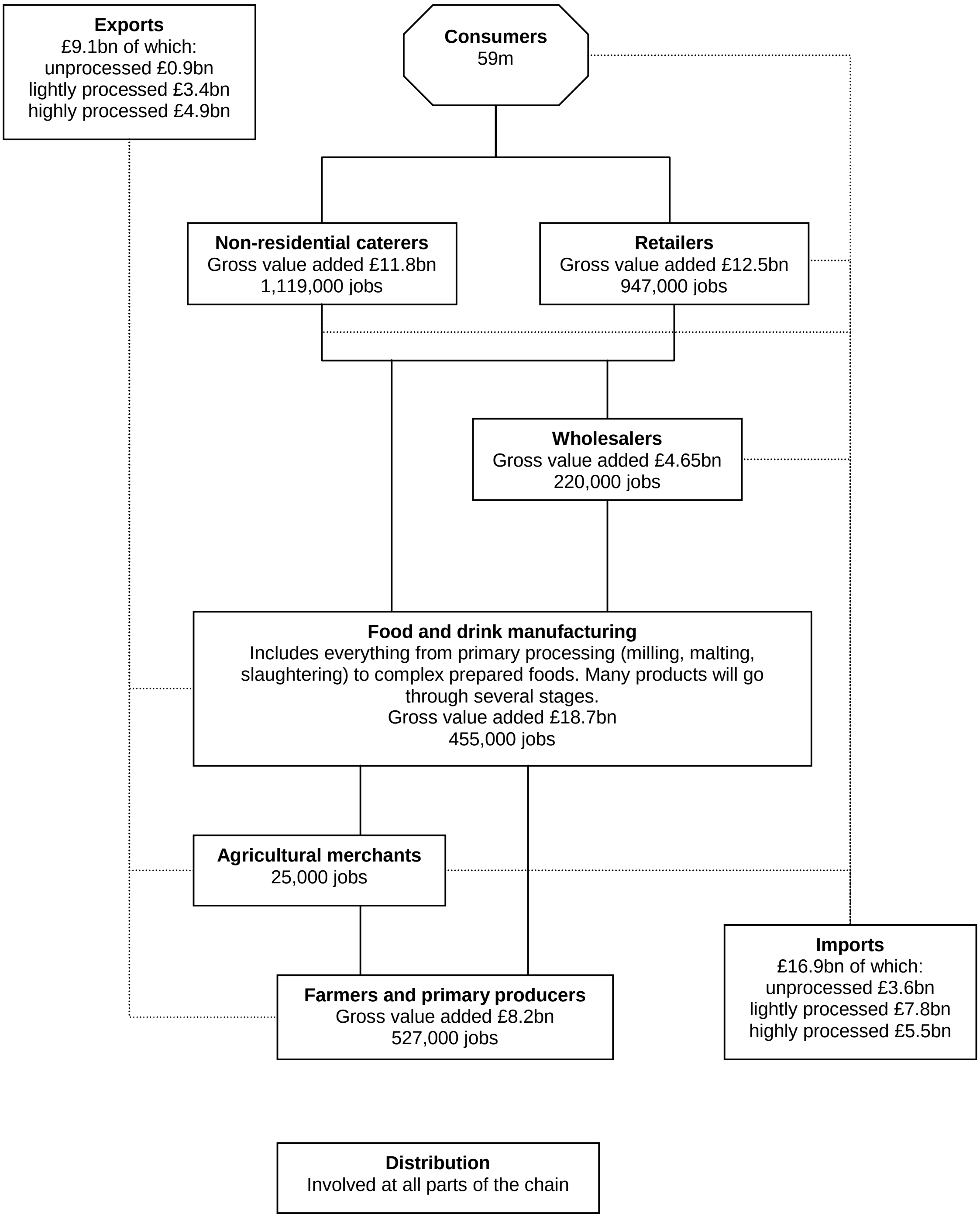
(c) improved product labelling and the dissemination of information at all points in the chain in order to strengthen consumer confidence;

(d) a better understanding of consumer concerns; and

(e) 'joined up' government to help deliver clear and consistent messages to consumers and to the business communities which collectively form the food chain.

FIGURE 11.1

The UK food chain



Source: Working Together for the Food Chain, Food Chain Group, November 1999.

Fresh meat

11.140. Particular concerns were expressed about the impact of retailer activity throughout the supply chain for fresh meat—particularly beef and, to a lesser extent lamb—in the wake of the 1996 BSE crisis (issues surrounding pork were rather different—see Appendix 11.6).

11.141. The BSE crisis in 1996 was coupled with a stronger exchange rate. We were told that domestic demand fell 12 per cent over the next two years, while the overseas market for lamb was hit by the stronger pound and the market for beef completely disappeared following an export ban. In 1996 to 1997, farm incomes held up, despite the decline in the beef market, as farmers benefited from additional measures to support the supply chain. Towards the end of 1997, however, farm incomes started to fall significantly, even though domestic demand had recovered somewhat, as export markets were still closed. The high exchange rate had resulted in increased competition from beef imports, and many of the additional support packages which had been put in place after the BSE crisis were also being reduced. During 1998 farmers' incomes fell sharply.

11.142. Farmers' representatives were concerned that the differential between retail and farm-gate prices increased considerably after 1996. They believed that all costs had been transferred to the producer while retailers maintained healthy margins.

11.143. Three separate studies into the relationship between producer prices and retail prices (the 'price spread') were presented to us during the course of the inquiry.

The London Economics report

11.144. In 1998, LE was asked by Tesco to examine the structure of the industry, the impact of the BSE crisis and the profitability of the various elements within it both before and after the crisis. Tesco told us that the object was to establish how far changes in retail prices reflected changes in producers' prices and the additional costs in the supply chain caused by the BSE crisis.

11.145. LE concluded that the price spread for beef increased after the BSE crisis (see Table 11.12). The absolute gap between the two in the period 1996/97 was, on average, about 23p per kg higher than the average for the period 1994/95.[1]

TABLE 11.12 **Real producer prices, retail prices and the price spread for beef 1990 to 1997 (in December 1997 prices)**

	Retail price p/kg	*Producer price p/kg*	*Price spread p/kg*	*Price spread % retail price*
1990	448.4	251.8	196.6	44
1991	428.1	239.4	188.7	44
1992	423.1	234.6	188.5	45
1993	460.5	271.4	189.0	41
1994	433.8	250.5	183.3	42
1995	425.7	244.4	181.2	43
1996	408.6	204.8	203.7	50
1997	389.8	182.4	207.4	53
Average 1994/95	429.7	247.5	182.3	42
Average 1996/97	399.2	193.6	205.6	52
Difference	–30.5	–53.9	23.3	10

Source: MLC; LE.

11.146. LE then identified increases in costs that followed the BSE crisis. It found that the increased price spread broadly reflected the increased costs on abattoirs, processors and retailers imposed by post-BSE regulations together with the costs of rebuilding the consumer market in beef. Its calculations indicated that these costs increased by around 25p to 27p per kg. This more than accounted for the increased price spread.

11.147. The LE study indicated that retail margins on beef sales before the BSE crisis were less than the average for the grocery sector, and that they remained tight or even negative. It said that figures from the MLC indicated that, even in late 1997 when the market had recovered significantly, margins at both

[1]LE concentrated on absolute price changes rather than percentages. When prices fall, the gap between producer and retail prices is magnified when it is expressed as a percentage of either. Moreover, because retail prices are higher than producer prices, the same absolute fall in both will appear as a higher percentage fall in producer prices than in retail prices.

the processing and retailing levels combined still amounted to only 10p out of the final retail price of over £3 per kg. It said that evidence from Tesco's accounts showed that these margins were insufficient to cover beef's share of store overheads. Thus, far from making profits on beef, even before the crisis, sales revenues failed to cover costs and the situation worsened following the crisis. It said that its supply chain analysis showed little scope, outside the rendering sector, for raising prices, so that increases in costs led directly to lower margins.

The Meat and Livestock Commission report

11.148. The MLC report examined trends in price spreads and multiple retailers' margins for beef, lamb and pork during the period 1995 to 1998. It found that price spreads had increased significantly over the period for all three meats. A key factor had been increases in costs and reduced revenues for by-products in the abattoir and processing sector:

(a) Reductions in the values of meat and bone meal, and of tallow, resulted in adjustments to the economics of rendering abattoir waste.

(b) The value of offal by-product returns fell very significantly over the period.

(c) Prices for lamb skins also fell from £6 per head to around £1 per head as a result of the collapse of the Russian and Turkish markets.

(d) Cattle hide values declined, although to a lesser extent than lamb skins.

(e) For beef, abattoirs which were selling certain high-priced cuts for export and were able to sell other cuts more competitively on the home market were unable to do so after March 1996 due to the loss of the export market.

(f) Processors had to bear higher charges for the Meat Hygiene Service and for the disposal of specified risk material.

11.149. The MLC noted other reasons for this gap widening over the period:

(a) The balance of cuts sold in multiple retail outlets altered significantly over the three years, for example more boneless cuts of pork and lamb were added to the product range.

(b) Prices in catering, processing and export markets (for lamb and pork) declined to a greater extent than those for products destined for the retail sector.

(c) Retailer pricing policies of levelling (that is absorbing fluctuations in producer prices) and averaging (that is, evening out price fluctuations between different meats).

(d) Time lags for changes in the producer price to be reflected in the retail price.

11.150. However, the MLC concluded that there had also been a rise in indicative retail margins. It said that these results could partly be explained by normal levelling behaviour by retailers at a time when producer prices were declining, and that these increases had been accentuated by the normal lags which occurred in the system. It said that it was also likely that the retail price series it had used in these calculations had not picked up all price reductions from special promotions. In addition, the prices were quoted in nominal terms, and had not been adjusted for inflation. Despite this it said that the figures suggested that:

(a) Multiple retailers had not shared any of the decline in overall industry return at a time when producer prices had declined very substantially.

(b) There was a wide variation in the prices charged at different multiple retail outlets and not all of this could be explained by quality differences.

However, it also observed that red meat tended to yield a lower margin than other food products. The calculations included in the MLC report indicated that indicative retail margins for beef, lamb and pork had risen in the period from July/September 1995 to July/September 1997 and again in the period from July/September 1997 to July/September 1998, as shown in Table 11.13.

TABLE 11.13 **Indicative retail margins, July to September**

£ per head

	1995	*1997*	*1998*
Beef	159–214	175–237	228–308
Lamb	13–18	20–27	21–29
Pork	20–27	24–33	26–35

Source: MLC.

The MAFF report

11.151. A report prepared by MAFF, in conjunction with a team of academic experts, in October 1999 set out the findings of a study exploring price transmission through the supply chain for beef, lamb and pork. It concluded that red meat price changes (both increases and decreases) were either fully or largely transmitted to the next stage in the food chain. However, the evidence also suggests that the full process of adjusting prices was stretched out over a number of months. The proportion of the price change that could be expected to be transmitted between stages in the food chain in the short run was always less than the eventual impact. Short-run price adjustments between wholesaler and retailer for beef and pork were much less powerful than between producer and wholesaler. It also found evidence of price levelling by retailers.

11.152. The MAFF report noted that the failure of changes in red meat price at one level in the food chain to be reflected immediately in downstream prices conformed with expectations that price transmission in the short run was less than in the longer run and that, whilst these results were consistent with how a competitive market with adjustment costs would behave, they could equally be consistent with market power in the downstream sectors of the marketing chain. The analysis did not assess whether the absolute size of the margin between prices and costs was set at a competitive level.

11.153. The report also examined whether the speed (as opposed to the degree) of price transmission was different for price falls and price increases, but the results were mixed or ambiguous. Only for pork was there consistent evidence that price rises were passed on faster than price falls. However, the analysis was based on list prices and therefore took no account of any tendency that might exist towards discounting in response to reductions in upstream prices.

11.154. The report suggested that disease-related press stories had had the effect of pushing red meat prices higher than they would otherwise have been. It said that the likeliest explanation was that, whilst any deflationary forces on prices as consumers cut back was likely to prove transient, these effects were more than cancelled out by the costs of the regulatory controls introduced and, unlike consumer effects, these would be permanent.

Our assessment

11.155. We invited interested parties, including Government departments and related bodies, trade, retail and consumer associations, and the principal parties for their comments. There was criticism of the MLC report from both the Consumers' Association and the retailers, on the grounds that its sample of retailers was too small, the timescale too short and it did not take into account other significant factors. The general conclusions of the LE report were widely accepted, even by producer interests, although the Consumers' Association thought that there had been some bias in its reporting of information. A summary of views is given in Appendix 11.8.

11.156. Overall there was little dispute that in the wake of the BSE crisis, costs in the supply chain rose significantly and the overall value of the carcass fell because of the reduction in the value of some of the by-products. At the same time, consumer demand for beef and lamb fell, making it impossible for retailers to raise prices.

11.157. There was also little dispute that the bulk of the effect of higher costs and lower value was felt by farmers. This is the outcome that would be expected in a broadly competitive market. Unless retailers had previously been making excessive profits on fresh meat, they would only have been able to pay producers more by reducing their own margins to less than a normal rate of return.

Other fresh produce

11.158. To determine whether the case of fresh meat was typical, we looked at other fresh produce. We asked the main parties to identify their suppliers of a range of products, and the wholesale and retail prices of the products. We then asked these suppliers for details of their sales to main parties and other retailers and the prices they received.

11.159. Our main interest was in fresh and short-life products, but we included some ambient groceries as comparators. We selected the products in order to achieve a mixture of branded, retailers' own-label and unbranded goods; goods supplied only from within the UK and goods which were also imported; and goods which were seasonal as well as those available all year round. The list of products was the same as that used in the analysis of the main parties' pass-through of wholesale prices (see Appendix 7.10). However, in that analysis we examined the relationship between wholesale and retail prices for each of the main parties. For this exercise we were interested in how individual suppliers' prices varied between their customers and how they related to costs.

11.160. More specifically, we wished to examine:

(a) differences in wholesale prices by UK retailer;

(b) pass-through from supplier costs to wholesale prices;

(c) pass-through from wholesale prices to retail prices; and

(d) supplier margins.

11.161. Our results are reported in Appendix 11.9. In general it was difficult to draw robust conclusions. The quality of the data was disappointing: the response rate—at 28 per cent—was low and few of the suppliers were able to give us sufficiently detailed information over a long enough period for detailed analysis. Our main findings were:

(a) Few of the respondents supplied information relating to anything other than sales to the large main parties (with the notable exception of the large suppliers of branded goods included for comparison purposes), so it was impossible to establish whether supplier relationships with main parties differed from those with other types of retailer in the UK or those with retailers in other countries.

(b) From the data available, we were unable to detect any consistent differences in the wholesale prices obtained by different main parties for these, generally small, suppliers.

(c) We were able to perform only limited analysis of pass-through of wholesale price changes to retail prices and, as prices and costs were available only on a quarterly basis, we were able to comment only on pass-through of price changes in the medium and longer term. However, the results appear to be consistent with the findings in Chapter 7, showing that, in general, wholesale to retail price transmission occurs fairly rapidly and completely. In two cases (carrots and lamb) there was evidence suggesting that retail price changes lead wholesale price changes, suggesting that suppliers may be responding to retailer promotions.

(d) The analysis of pass-through of supplier cost changes to wholesale prices gave mixed results, with some products showing rapid and complete pass-through, and others appearing to have no close relationship.

(e) The suppliers of retailers' own-label bread, lettuce, apples, eggs, lamb and chicken were found, by and large, to be selling these products at a net loss.

(*f*) We found no evidence to suggest that pass-through occurs in an asymmetrical fashion (that is, price rises and price falls being passed through differently) in the long term. However, given the fact that we were using aggregated data, this does not rule out the existence of short-term asymmetry.

International comparisons

11.162. Other countries have introduced legislation to limit the extent to which major food retailers can exert buyer power over their suppliers. The position in France, Germany and Ireland is set out in Appendix 11.10. All three countries have introduced legislation to protect suppliers and/or small retailers. The main emphasis has been on barring below-cost selling but some other supplier issues have been addressed. There appear to have been problems in implementing the legislation in all three countries, partly because suppliers are, naturally, reluctant to instigate legal action against important customers and partly because of problems of definition (for example, of exactly what constitutes 'below-cost' selling).