

EXECUTIVE SUMMARY

Introduction

The Competition Authority has undertaken the *Grocery Monitor* project at the request of the Minister for Enterprise, Trade and Employment to monitor the grocery sector for the foreseeable future in light of recent changes in the legislative and regulatory environment. The request was made following the repeal of the Restrictive Practices (Groceries) Order, 1987 (the 'Groceries Order') on March 20th 2006 and the insertion of sections 15A, 15B and 15C in the Competition Act, 2002 which addresses certain business practices in the grocery sector.

The Competition Authority decided, given available resources, to prepare an initial set of three reports that together provide a comprehensive description of the evolution of the grocery sector with respect to market structure and competition at the wholesale and retail levels, retail pricing trends and the effects of the planning system on expansion and entry at the retail level.

This *Report* (Report No. 1) examines market structure and competition at the wholesale and retail levels of the grocery sector from 2001 to 2006. A second report, which is being published at the same time, describes retail pricing trends in the grocery sector from 2001 to 2007. The third report (Report No. 3), which will be published later in the Spring, considers the planning system as applied to expansion and entry of retailers in the grocery sector from 2001 to 2006.

Overview

For the purposes of this *Report*, the term 'grocery goods' is used to refer to food and drink for human consumption and household necessities. The Competition Authority believes this definition corresponds closely to what households consider as groceries.

For the purposes of this report, three types of operators are identified at the retail level:

- Vertically-integrated retailers who own and operate multiple retail outlets across the State (and in effect, carry on their own wholesaling);
- Affiliated retailers who typically own and operate one retail outlet (and in limited cases, several outlets) under a retail brand or fascia which is

used by other retail outlets and is under license from a wholesaler-franchisor (as defined in this report); and

- Independent retailers who own and operate a retail outlet under a unique retail brand or fascia and who are not affiliated with a wholesale-franchisor.

For the purposes of this report, two types of wholesale operators are identified:

- Wholesaler-franchisors who engage in the traditional function of buying goods from suppliers for resale to retailers and who license one or more retail brands or fascias to retailers; and
- Wholesalers who are engaged in the traditional function of buying goods from suppliers for resale to retailers (and by definition, do not license a brand or fascia to retailers).

Based on information gathered for the project, the Competition Authority has estimated the size of the wholesale and retail levels of the grocery sector in Ireland. For 2006 these estimates are as follows:

- Wholesale: Turnover of €4.7 billion of which €3.6 billion is attributable to grocery goods (as defined in this *Report*); and
- Retail: Turnover of €14.6 billion of which €11.6 billion is attributable to grocery goods (as defined in this *Report*).

The Wholesale Level: Market Structure and Competition

The Competition Authority estimates that over 95% of the wholesale turnover in the Irish grocery sector is attributable to seven groups of operators. There are six wholesaler-franchisors (as defined in this *Report*): ADM Londis, Barry Group, BWG Foods, the Gala Wholesalers, Mangan Wholesale and Musgrave. There is also a group of 12 independent cash and carry wholesalers. This group, along with Barry Group, the Gala Wholesalers and Mangan Wholesale, forms the Stonehouse buying group. In this *Report*, the group of 12 independent wholesalers is referred to as the 'Other Stonehouse Members'.

Given the overwhelming importance of the seven major wholesale groups, the Competition Authority ignores for the purpose of this *Report* the activity of the wholesalers who account for less than 5% of wholesale turnover.

Each of the six wholesaler-franchisors licenses the use of a retail brand or fascia under a franchise agreement to retailers (its affiliated retailers) and sells goods at wholesale predominantly to its affiliated retailers. For example, Musgrave licenses the use of the Centra and SuperValu brands, BWG Foods licenses the use of the SPAR brand and ADM Londis licenses the use of the Londis brand.

In 2006, the combined turnover of the seven major wholesale groupings was €4.7 billion. This represented growth of 56% in nominal terms from 2001 (35% in real terms). Over the entire period from 2001 to 2006, the share of wholesale turnover attributable to the sale of grocery goods was relatively constant at 76%.

The wholesale level of the grocery supply chain is highly concentrated. Musgrave and BWG Foods, two wholesale-franchisors, together account for almost 80% of the €3.6 billion grocery wholesale turnover generated in 2006. Over the period 2001 to 2006, the relative market position of each of the wholesale groupings remained unchanged with shares of turnover being relatively stable.

The wholesalers differ in a number of respects. Firstly, wholesalers differ with respect to the importance of different types of customers. The wholesalers have three main customer types: their affiliated retailers, other retailers and other customers, who are principally involved in catering.

For most of the wholesalers, their affiliated retailers are their most important customers. In 2006, affiliated retailers accounted for just over 78% of grocery wholesale turnover on average across all wholesalers. For ADM Londis, affiliated retailers accounted for almost all grocery wholesale turnover, while for the Gala Wholesalers sales to affiliated retailers accounted for just 29% of the grocery wholesale turnover.

Secondly, wholesalers have different distribution capacities. Wholesalers make use of three different distribution channels: delivery of goods that have been stored at the wholesaler's warehouse, direct delivery by suppliers to retailers and goods that are collected by customers from cash and carry centres. Distribution capacity principally involves warehousing. For 2006, on average across the wholesalers, approximately 62% of wholesale grocery goods turnover came from goods delivered by wholesalers; 34% came from

goods delivered directly by suppliers; and 4% of grocery goods turnover came from goods that were collected by customers.

Musgrave, with the greatest amount of warehousing floor space of all the major wholesale groups, derives 79% of its grocery wholesale turnover from sales of goods delivered to their customers, 19% from sale of goods delivered directly by suppliers and just and 2% from the sale of grocery goods that are collected by retail customers. At the other end of the spectrum is ADM Londis which, with the smallest amount of warehousing floor space, derives approximately 15% of its grocery wholesale turnover from the sale of grocery goods that are delivered to customers with the remainder of wholesale grocery turnover coming from goods that are delivered directly by suppliers.

Finally, wholesalers differ with respect to their geographic scope. While each of the wholesaler groups has customers located across the State, as of 2006 some wholesalers had more of a regional presence than a national presence. Customers of Mangan Wholesale, for example appear to be more concentrated in Connacht and Ulster regions. Customers of BWG Foods and Musgrave appear to be distributed relatively evenly throughout the State.

Given this market structure in which over 78% of wholesale turnover is derived from sales to affiliated retailers, competition at the wholesale level in the grocery sector over the period 2001 to 2006 is focussed on the efforts by wholesaler-franchisors to compete for retailers to become or remain their affiliated retailers and to increase sales of goods to these affiliated retailers.

At its core, wholesaling involves the purchase of goods from suppliers for resale to retailers and other customers. Wholesalers have traditionally been involved in varying degrees in the provision of storage, distribution and other services in connection with the sale of goods.

The principal innovation of modern wholesaling is the emergence and growth of wholesaler-franchisors, that is, wholesalers which sell predominantly to retailers who are affiliated to them. The development of the relationship with affiliated retailers has been the main focus of wholesaler-franchisors in order to increase wholesale turnover from sales of goods. The relationship between a wholesaler-franchisor and its affiliated retailers consists principally of an agreement to license a retail brand or fascia to retailers and to require or to encourage the affiliated retailers to buy all or most of their requirements from the wholesaler-franchisor. To develop and reinforce this relationship, the

wholesaler-franchisor strives to offer attractive wholesale prices and rebate policies to its retailers as well as to provide various types of support services to its affiliated retailers to improve their profitability.

Thus, modern wholesaling is very much involved with developments at the retail level. Under the franchise agreement with its affiliated retailers, the wholesaler-franchisor offers these retailers the opportunity to operate their outlets under a common brand. From the perspective of the affiliated retailer, it believes that its outlet will operate more profitably than if it operated under its own brand (as an independent retailer) or under a brand of another wholesaler-franchisor. The success of affiliated retailers would be expected to enhance the profitability of the wholesaler-franchisor.

Thus, the wholesaler-franchisors offer a wide variety of support services to their affiliated retailers which are designed to improve the viability and profitability of the outlets of the affiliated retailers.

The licensing of a retail brand implies that wholesalers as wholesaler-franchisors are now involved in the branding of retail outlets and the marketing of the brand. They assist affiliated retailers with the choice of products they retail and recommend the prices at which they sell those products. Wholesalers are also involved in a variety of the logistical aspects of retailing including product ordering, stock management, billing and business planning, particularly with newly-affiliated retailers.

The net effect of the emergence and development of the wholesaler-franchisor in the wholesaling of grocery goods is that wholesalers and retailers have become more integrated and in some respects mimic the business models of the vertically-integrated retailers who combine wholesaling and retailing in a single business entity.

The trend toward the deepening of the wholesaler-retailer relationship explains, in part, the relative stability of turnover shares. While the modern wholesaler-retailer relationship holds advantages for both sides, the principal advantage from the point of view of the wholesaler is that it helps ensure a stable and ongoing demand for the products that it wholesales. In this regard it is noteworthy that switching rates among affiliated retailers are relatively low.

A further explanation for the relative stability of turnover shares of the main wholesaling groups may relate to the nature of distribution logistics and their

potential to inhibit entry. The Competition Authority is not aware of any new entrant of any material size at the wholesale level over the period 2001 to 2006.

The use of a proprietary distribution network appears to be an important barrier to entry. It is not an essential requirement for entry; however, the absence of a proprietary distribution network together with other factors such as economies of scale, economies of density and switching costs for retailers who are affiliated with wholesaler-franchisors, make entry difficult at the wholesale level.

The Retail Level: Market Structure and Competition

The Competition Authority estimates that there were over 6,400 grocery retail outlets in the State as of December 31st 2006 of which 55% are operated by independent retailers (3,498 outlets), 40% by affiliated retailers (2,569 outlets) and about 5% by vertically-integrated retailers (337 outlets). There has been considerable expansion by the main retailer groups in the State over the period 2001 to 2006. The number of retail outlets belonging to the vertically-integrated retailers has almost doubled since 2001, as has the number of retail outlets belonging to affiliated retailers. In contrast, the number of retail outlets belonging to independent retailers fell by 44% between 2000 and 2006 reflecting a much longer-term trend.

The Competition Authority estimates that vertically-integrated retailers together account for 46% of the €11.6 billion retail turnover in grocery goods in the State for 2006. The retailers which are affiliated to the four largest wholesaler-franchisors account for 40% of retail grocery turnover while the other retailers, independent retailers and retailers affiliated to smaller wholesaler-franchisors account for 14%.

The six vertically-integrated retailers are ALDI, Dunnes Stores, Marks & Spencer, Lidl, Superquinn and Tesco.

Six wholesaler-franchisors license 18 retail brands or fascias in the grocery sector. ADM Londis has two brands: Londis and Londis Topshop. The Barry Group has two brands: Costcutter and Quikpick. BWG Foods has three brands: MACE, a group of interrelated brands under the names SPAR, EUROSPAR and SPAR Express, and XL Stop & Shop. Gala Retail Services has the brands Gala, Gala Superstore, Gala Xpress and Checkout. Mangan

Wholesale operates three brands: MACE, Vivo and Xpress Stop. Musgrave has four brands: Centra, Daybreak, DayToday and SuperValu.

By definition, independent retailers are neither vertically-integrated retailers nor affiliated retailers and operate under their own unique brand or fascia.

The Competition Authority was able to gather historical information for the period 2001 to 2006 about the vertically-integrated retailers and about affiliated retailers which are associated with the four largest wholesaler-franchisors.

For 2006, the combined turnover of those retailers was €12.6 billion which was 86.1% of estimated total turnover for that year (€14.6 billion). This represented a nominal growth in turnover of 70%, from €7.4 billion in 2001. For 2006, the combined grocery goods turnover of those retailers, for which historical information was available, was €10.0 billion which was 85.9% of estimated total grocery goods turnover for that year (€11.6 billion). The proportion of grocery goods turnover as a share of overall turnover fell during the period 2001 to 2006, from 82.3% to 79.1%, indicating the growing importance of non-grocery items for grocery retailers.

During 2006, among the vertically integrated retailers, Tesco and Dunnes Stores had the greatest shares of turnover, between them accounting for almost 33% of total grocery goods turnover in the State. Across all fascias, that is, fascias operated by both vertically-integrated and affiliated retailers, Tesco, SuperValu and Dunnes Stores had the greatest shares of turnover, accounting for approximately half of grocery goods turnover in the State. Between 2001 and 2006, the relative market positions of each of the major retailing groups remained unchanged, though all lost some share to the recent entrants Lidl and ALDI.

As of year-end 2006, the vertically-integrated retailers and affiliated retailers had combined grocery net retail floor space of 1.1 million m². While the Competition Authority was unable to gather reliable historical information about all retailers on retail floor space, it appears that the total figure for retail floor space in the State has grown considerably since 2001. This increase is largely attributable to the growth of the vertically-integrated retailers. Floor space belonging to the vertically-integrated retailers increased by almost 62% in the period between 2001 and year-end 2006.

Generally speaking, the retail groups with the highest share of turnover have the highest volume of retail floor space and the greatest number of outlets.

In varying degrees, all retailer groups have a presence across the State. As of year end-2006, Tesco and Dunnes Stores had the widest geographic distribution of the vertically-integrated retailers, though the rapid expansion of ALDI and Lidl over the period 2001 to 2006 implies a growing national presence. Among the affiliated retailers, affiliated retailers of the two largest wholesaler-franchisors, Musgrave and BWG Foods, had an even distribution of outlets across the State. The other groupings of affiliated retailers tend to be more regionally concentrated.

At the retail level, retailers are faced with consumers with a diverse set of characteristics and tastes. Among the important differences are differences in location, purchasing patterns, product preferences and brand preferences. In response, retailers have evolved in different ways to seek the custom of these consumers, principally through choice of pricing and promotional policies, product range and location of retail outlets.

The vertically-integrated retailers tend to pursue national pricing and promotional policies, offer a broad range of products including well developed lines of own-label products that cater for a variety of tastes and to locate in more urban areas with larger retail outlets often in shopping centres. Notwithstanding these general tendencies of the vertically-integrated retailers, there are some notable differences.

Lidl and ALDI tend not to locate within shopping centres, opting instead for standalone locations. Dunnes Stores, Tesco and Superquinn offer a comparable product range. Lidl, ALDI and Marks & Spencer all tend to have very focused product ranges with own-label (including exclusive label) goods featuring prominently. These retailers have a similar number of product categories but more limited product depth than the other vertically-integrated retailers. Unsurprisingly, outlet size appears to be closely related to the extent of product range on offer. Accordingly, Lidl and ALDI, whose outlets tend to be relatively uniform in terms of size, are somewhat smaller than those of the other vertically-integrated retailers.

The affiliated retailer groups differ fundamentally from the vertically-integrated retailers. Affiliated retailers tend to have a much wider geographic dispersion than the vertically-integrated retailers, locating in both urban and

rural locations. They tend to carry a narrower product range than the vertically-integrated retailers and operate smaller outlets. Affiliated retailers also tend to have longer opening hours. While wholesaler-franchisors recommend prices to their affiliated retailers, they are legally prevented from enforcing their recommendations. The affiliated retailer groups therefore tend to exhibit price variation across outlets, in part, because outlets operating under the same brand are owned by retailers who are independent of each other and the wholesaler-franchisor to which they are affiliated.

The SuperValu group of affiliated retailers is exceptional. In many respects, the outlets of SuperValu retailers are similar to outlets operated by the vertically-integrated retailers. Outlet size, product range and the extent of development of their own-label offering all imply that SuperValu retailers are comparable to those of the vertically-integrated retailers. Unlike the vertically-integrated retailers, SuperValu affiliated retailers are present in less urbanised areas. One implication of this is that on an outlet to outlet basis, SuperValu retailers tend to face the least number of similar competitors relative to outlets of the vertically-integrated retailers.

The vertically-integrated retailers and the affiliated retailers appear to satisfy different consumer requirements. The offering of the vertically-integrated retailers is targeted primarily at one-stop shoppers. In contrast, affiliated retailers satisfy top-up or convenience requirements. The exception is the SuperValu group of affiliated retailers.

Apart from the SuperValu exception, there are two other important exceptions. Firstly, the vertically-integrated retailers have begun to serve top-up or convenience shoppers, for example, the opening by Tesco of outlets under the Tesco Express brand, to serve city centre convenience shoppers. A number of the other vertically-integrated retailers have made similar moves.

Secondly, some affiliated retailers also target the one-stop shopper. The principal driving factor behind grocery retailing is population density. The population density required to support a typical outlet of a vertically-integrated retailer is greater than that required to support a smaller outlet of an affiliated retailer. While this explains the wider geographic distribution of affiliated retailers, it also explains why, in more rural locations where population densities are lower, affiliated retailer often serve the one-stop shopper as well.