Retail-related Import and Distribution Study

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The Competition Authority
An tÚdarás Iomaíochta

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EXECUTIVE SUMMARY

The Tánaiste's Request

On 25th February 2009 the Tánaiste and Minister for Enterprise, Trade and Employment, Ms. Mary Coughlan, TD, asked the Competition Authority to carry out a study of the retail-related import and distribution sector.

The Tánaiste's request was made in the context of a steady increase over the previous 12 months in the difference between prices in the Republic of Ireland and Northern Ireland. As sterling depreciated relative to the euro, price surveys and anecdotal evidence suggested that a substantial price differential had emerged on a wide range of consumer products, from kettles to ketchup. Large numbers of price-conscious consumers in the Republic of Ireland were travelling to Northern Ireland to take advantage of the lower prices available there. Policy-makers were naturally concerned as to why retailers in the Republic of Ireland were not lowering prices, especially prices of goods coming from the UK.

Retailers claimed that higher costs of doing business in the Republic of Ireland contributed to the price differential. In response to these claims, the Tánaiste asked Forfás to undertake an analysis of the costs of running retail operations. Forfás' research, published in December 2008, found that, while the cost of doing business in the Republic of Ireland was 25% higher than in Northern Ireland, this would only account for a 5-6% price difference, approximately.

Some retailers then claimed that a substantial portion of the price differential could be explained by the fact that their suppliers in the UK would not pass on exchange rate benefits. Subsequent to these new explanations by retailers for the persistent price differential, the Tánaiste asked the Competition Authority to undertake this study.

Scope of the Report

The Competition Authority pursued its inquiry into the retail-related import and distribution sector along two complementary lines. The first line of inquiry focused on the broader economic environment, exchange rate movements, and when market power can be harmful in a supply chain. The second line of inquiry focused on the supply chains to the grocery, clothing and pharmaceutical sectors. The Competition Authority relied on a wide variety of information sources.

This Report falls under the advocacy role of the Competition Authority in studying sectors of the economy and advising the Minister. Any potential breaches of competition law in any retail sectors therefore lie outside the scope of this Report.

Key Findings

The Irish economy is going through a period of major adjustment at present. The impact of the global economic downturn is being felt across a range of sectors. Financial, property and labour markets, for example, are in the midst of a particularly painful correction. Retail markets, and therefore the supply chain structures that serve them, are no different in this respect.

The examination of the three sectors contained in this Report clearly demonstrates that both retailers and the suppliers that service them, generally do react and are reacting to changing consumer behaviour. The extent and nature of their reaction depends to a significant extent on the flexibility of the supply chain as well as the level of competition.

- In the groceries sector, retailers are pressuring suppliers for better deals and finding alternatives and prices to consumers have fallen somewhat as a result. Relatively weak competition at the wholesale and retail levels of the Irish grocery supply chain might be limiting price reductions to consumers.
- In the clothing sector, sales and promotions abound. Low cost clothing retailers, such as Penneys, have more alternative supply options than the branded clothing retailers with tightly controlled supply chains. Resellers of branded clothing (e.g. sports stores, department stores) have the most difficulty in renegotiating prices with suppliers.
- The pharmaceutical sector is different again. The highly regulated nature of the market and the pre-eminent role that the State plays as the largest purchaser of medicines limits retail price competition and alternative sources of supply. Pharmacies and consumers are therefore unlikely to see significant price reductions on medicines.

The retail sector and its associated suppliers will continue to adapt and work better for consumers, unless any artificial restriction is imposed on competition. Their focus is their consumers and they respond to changes in consumer choices. In many ways, the current behaviour of both retailers and suppliers show the power that consumers can have. When consumers switch away from a retailer, or from a brand, and try out alternatives, the retailer or supplier has no choice but to up their game and compete to win the consumer back.

What does compound difficulties for both retailers and suppliers, however, is the fact that our nearest and most significant trading partner, with whom we share a land border, has seen a competitive depreciation of their currency and has a lower cost of doing business.

Currency devaluation is no longer available to the Republic of Ireland due to our adoption of the euro. The depreciation of sterling is a relatively short term phenomenon, but it has exposed the more fundamental problems of certain retail sectors and the cost of doing business in Ireland.

The problem of the Republic of Ireland's higher cost base is a much more long-term threat to the competitiveness of retailers, suppliers and all businesses in Ireland. This problem is within our control. Labour, energy and other utility costs, as well as costs associated with professional and other services, contribute to a higher cost of doing business in the Republic of Ireland. Tackling factors that raise the cost of doing business is the best way of ensuring that Irish retailing and production sectors are capable of competing with their counterparts in the UK and beyond.

The high concentration of the Republic of Ireland's grocery retailing sector and the high mark-up on medicines here have been highlighted by the Competition Authority previously. The Authority has recommended reform of the Retail Planning Guidelines to better facilitate new competition to existing retailers in towns around Ireland. The mark-up paid to pharmacies for medicines under the State's Drugs Payment Scheme - which effectively is also the mark-up paid by private individuals for medicines - should be brought down from 50%, one of the highest in the EU (to a much lower level and, preferably, to a set fee rather than a percentage fee). These reforms would bring benefits to consumers.

Broad Context

A number of factors can contribute to retail price differences between the Republic of Ireland and Northern Ireland. Differences in the cost of doing business, scale, tax regimes, consumers' incomes and tastes, levels of competition and regulations, all affect the pricing options and decisions of both retailers and suppliers.

While the focus of the Report is on the supply of imported goods for retail in Ireland, it is important to keep in mind that prices are always determined by both demand and supply conditions. Pricing decisions, by retailers and manufacturers, are made in the context of what consumers are prepared to pay.

The Republic of Ireland has been through a period of unprecedented economic growth with high wages, low taxes and greater access to credit. Thus disposable incomes in the Republic of Ireland have been higher than in Northern Ireland for some time, and consumers here less price-sensitive as a result. Exporters frequently "price-to-market", that is, they will set their mark-up in each country according to the demand conditions they face.

The cost of doing business in the Republic of Ireland is generally higher than in Northern Ireland. VAT levels are also higher, and the gap was made wider in 2008 when UK VAT levels fell and Republic of Ireland VAT levels rose.

Exchange Rate Pass-through

There have been two substantial depreciations in the value of sterling against the euro over the past year. This recent volatility contrasts sharply with the preceding period of enduring exchange rate stability. The fall in the relative value of sterling has led to the expectation that imports from the UK should be cheaper.

Exchange rate pass-through is invariably neither immediate nor complete. In other words a 10% appreciation in the value of the euro against sterling (or any other currency) does not guarantee a 10% fall in import prices, neither immediately nor eventually. Empirical studies indicate that, for the entire euro zone, a 10% appreciation of the euro may only lead to a 6-7% fall in import prices in the short run and 8% in the long run. Pass through rates for the Republic of Ireland are thought to be even lower - a 10% appreciation of the euro may only lead to a 5% fall in import prices in the short run and just under 6% percent in the long run. Eventual pass-through to consumer retail prices is still less again.

There are a number of plausible reasons why weaker sterling does not lead to lower retail prices here, lack of competition is just one:

- Even though certain goods are imported from the UK, they are very often not produced there. For example, a cotton t-shirt is typically manufactured in the Far East, and paid for by the retailer in US dollars; it may simply pass through the UK on its way to an Irish store. Even for goods that are manufactured in the UK, the cost of the raw materials may be paid in a currency other than sterling. For example, coffee beans and cocoa beans are traded in US dollars. The food industry is truly a global one, with the path from the farm to the dinner plate becoming increasingly complicated. It is rare to find any retail good on sale in Ireland that is 100% grown, processed and manufactured in the UK. Indeed, the UK, like Ireland, does less and less manufacturing then in previous decades. Therefore, the real "savings" to a supplier arising from a sterling depreciation – the savings that could be expected to "pass-through" to retailers in Ireland - are limited to the proportion of the supplier's costs that are in sterling.

- Where savings do arise, they can be kept back by suppliers and/or retailers, if competition is weak. Whether it is the retailer or the supplier who keeps a greater share of the savings depends on the relative bargaining strengths of the parties. Retailers who face a low level of competition face less pressure to pass on savings to consumers and to extract savings from suppliers in the first instance.
- Hedging involves, for example, buying currency in advance to protect the business from exchange rate volatility – like choosing to have a fixed-rate mortgage on your house. In these circumstances, currency movements do not yield an immediate benefit (or cost) to the buyer and pass-through can only happen in the medium to long term.
- The ease with which retailers (and other operators along the supply chain) can take advantage of alternative and better-value supply options affects pass-through. The less flexibility a retailer has to obtain suitable alternative supplies, the slower pass-through will be.

The speed and extent to which retail prices in the Republic of Ireland and Northern Ireland can be expected to converge is to a significant extent dependent on the prevalence of these factors and will vary from product to product.

Market Power in a Supply Chain

If the consumer price differential that has emerged between the Republic of Ireland and Northern Ireland is to narrow, retailers must, without exception, seek to reduce their costs. Cost reductions can come from examining internal efficiency and from pressurising suppliers for better deals or seeking better deals elsewhere.

It is therefore of the utmost importance that the abusive exercise of market power is not confused with <u>legitimate</u> actions by businesses seeking to protect their business in the face of the fall off in consumer spending and Irish consumers' expectations for lower prices.

Sector Level Experience

Groceries

Grocery retailers, intermediaries and suppliers are all reacting to changing consumer behaviour as a result of the recession and the widening of the price differential with Northern Ireland.

- *Retailers and Wholesalers*: The larger retailers and wholesalers have been better able to obtain reduced prices and more promotions from suppliers than the smaller operators. Where retailers have not achieved sufficiently lower prices with existing suppliers, retailers have looked for alternatives. For example, Tesco has announced that it is by-passing Republic of Ireland offices of international brands and third party distributors by moving to the UK for direct supply for many grocery items. It can do so because it has a centralised distribution system in place to facilitate direct imports on the required scale, i.e., imported goods can be delivered to a central hub from which Tesco distributes the goods to all its stores. Other retailers and wholesalers have taken other routes, with a number buying from wholesalers in Northern Ireland and UK buying groups. Some retailers have substituted products with another brand. Lidl and Aldi source almost no product via the UK, rather they use an extensive eurozone supply base, and so are relatively unaffected by the euro/sterling exchange rate. They are also benefiting from consumers switching to their stores.

- *Suppliers of International Brands with Republic of Ireland Offices*: Some Republic of Ireland offices of international brands have been successful in negotiating price reductions with their parent companies and, in turn, have reduced their prices to retailers. Others have been given more discretion to increase in-store promotions. Some suppliers prefer to give deeper promotions – e.g. 50% off rather than 33% off - to ensure that price reductions go fully to the consumer, and because they do not want to renegotiate a price increase with retailers if sterling begins to appreciate against the euro again.
- *Independent Importer-distributors*: Independent importers-distributors have found it more difficult to renegotiate prices with UK offices. An international branded company has less incentive to reduce prices to an independent distributor, as it still makes sales and profit if the retailer buys their products from a Northern Ireland distributor or direct from the UK office. Retailers and wholesalers have stopped renewing contracts with Irish importers-distributors if they cannot get sufficient price reductions.

Apart from the general factors that can contribute to retail price differences between the Republic of Ireland and Northern Ireland, a number of other factors contribute specifically to the price differential in groceries. First, the retail and wholesale levels of the Irish grocery supply chain are relatively concentrated. Republic of Ireland consumers have less choice when they shop around. This factor, when coupled with the fact that Irish consumers have been less price-sensitive in recent years, means that there has been relatively little pressure on retailers to price aggressively.

Second, the Republic of Ireland’s grocery distribution systems are inefficient relative to the UK. The UK distribution model is built on fully-developed central distribution systems which enable retailers to deliver a huge variety of groceries to their retail outlets in a single visit. Republic of Ireland retailers and wholesalers have varying capabilities to do this, and there are considerable differences in the sizes of the networks they control, with Tesco having by far the most efficient system. Northern Ireland is part of a wider UK market and uses the more efficient distribution structure of the UK. Also, the cost of transporting goods across the Irish Sea is shared out across the whole of the UK’s retail network.

Finally, differences in planning regulations between the Republic of Ireland and Northern Ireland have had an impact. The Retail Planning Guidelines make it more difficult for new retailers to establish a significant presence in the Republic of Ireland to be able to compete with Tesco, Dunnes, Superquinn and Supervalu. They prevent some of the low-cost grocery retailers that operate in Northern Ireland, such as Asda, from opening stores in the Republic of Ireland without significantly altering their business strategy and the prices they can offer Republic of Ireland consumers.

Clothing

In 2007, clothing and footwear prices in the Republic of Ireland were lower than in the UK. By 2009 this situation had reversed. The clothing price differential is very evident to Irish consumers due to the practice of dual-ticketing (where euro and sterling prices are shown on the same label) engaged in by many clothing retailers who have a presence in the UK as well as the Republic of Ireland.

Clothing brands differentiate themselves in terms of price, quality and design. The clothes are generally manufactured in mainland Europe and the Far East.

The depreciation in the value of sterling and the recession have led to a fall off in demand for clothing generally, though low cost retailers appear to be benefiting from consumers switching to them from more expensive brands. Retailers have responded by increasing sales/discounts and promotions, and in some instances by re-ticketing items to bring down the euro price.

The extent to which clothing retailers may reduce prices is dependent upon the extent to which they can reduce their costs. Their ability to reduce the amount they pay for the products they sell is constrained by three elements; the seasonality of the clothing market, limited buyer power and the ability to switch sources of supply.

- *Seasonality in the Clothing Market*: The prices paid by retailers to suppliers for clothes currently appearing in Republic of Ireland stores were set six to twelve months ago and renegotiating those prices is difficult, though retailers have indicated that they have had some limited success.
- *Limited Buyer Power*: The extent to which retailers can negotiate lower prices is dependent on their buyer power. Republic of Ireland stores that have access to stock through related UK stores have slightly more scope to access products at sterling prices. In some instances Irish retailers have been able to switch to paying in sterling but in the main they have not.
- *Switching Sources of Supply*: The ease with which clothing retailers may switch to alternative better-value sources of supply depends upon the type of clothing that they retail. Low cost retailers, e.g., Penneys, can most easily switch sources of supply, though with a time lag (due to seasonality). Such retailers are not so aligned with any particular manufacturer. The supply chains of the mid-range retailers who operate wholly-owned retail outlets and sell a single clothing brand, e.g., River Island, Topshop, Wallis and Warehouse, are far less flexible. These retailers tend to have an international presence; purchasing and distribution arrangements for Republic of Ireland outlets are typically determined centrally. Clothing retailers who resell a range of brands (e.g., sportswear stores and department stores) also have limited ability to switch sources of supply. Such retailers argue that they have long-term relationships with branded clothing suppliers which they need to maintain. Alternative sources for a particular brand cannot be relied on to come in the full range of sizes or colours or to be from the current season.

The retail and supply landscape of the Republic of Ireland does not appear to differ hugely from that of Northern Ireland. A notable feature of clothing retail is the apparent low level of alternatives for many retailers. With the exception of low cost clothing, competition in clothing is largely about branding and image, within a particular price/quality range. Thus, it is difficult for stores with ongoing relationships with brands to switch to alternative brands.

As the seasons roll on and the seasonal pattern of sales continues, all brands have the opportunity to set Republic of Ireland and Northern Ireland prices in a way that reflects more recent exchange rates.

Pharmaceuticals

The prices of the vast majority of medicines in the Republic of Ireland and the UK (and thus Northern Ireland) are determined by State policy. Approximately 80% of the value of all medicine sales in the Republic of Ireland is recouped from the State, effectively making it the single largest buyer of pharmaceutical products in the Republic of Ireland.

As part of the tight controls on the sale of medicines in the Republic of Ireland, retailers and wholesalers are legally restricted from going outside the Republic of Ireland for supplies of pharmaceuticals - with the exception of a very small number of specially-licensed importers who, typically have less than 5% of the Republic of Ireland wholesale market.

The impact of the sterling depreciation has been negligible in terms of reducing sales or lowering prices of medicines in Republic of Ireland. Demand for medicines is always relatively stable, even the recession has had only a small impact. The sterling depreciation has given a boost to licensed importers but they are such a tiny part of the supply chain that there is little or no benefit to consumers.

1. Introduction

The Ministerial Request

1.1 On the 25th February 2009 the Tánaiste and Minister for Enterprise, Trade and Employment, Ms. Mary Coughlan, TD, requested that the Competition Authority carry out a study of the retail-related import/distribution sector, and report by 30th April 2009 (the full text of the Tánaiste's request is included in Appendix A). A draft of this report was submitted on 30th April 2009, with the final version delivered on 14th May 2009 and published on 30th June 2009.

1.2 The Competition Authority is the public body with responsibility for, *inter alia*, promoting competition and enforcing Irish and European competition law in the State. It works principally within the framework of the Competition Act 2002 ("the Act") and the Treaty establishing the European Community ("Treaty") in conjunction with Council Regulation (EC) No. 1/2003. The mission of the Competition Authority is to ensure that competition works well for consumers and the Irish economy.

1.3 Pursuant to section 30(2) of the Act, the Minister for Enterprise, Trade and Employment may request the Competition Authority to carry out a study or analysis of any practice or method of competition affecting the supply and distribution of goods or the provision of services or any other matter relating to competition and submit a report to the Minister in relation to the study or analysis; the Competition Authority is required to comply with such a request within such a period as the Minister might specify in the request.

1.4 The Tánaiste's request was made in the context of the recent Forfás report which suggested that "the fact that the strong euro does not appear to be translating into lower import costs may be indicative of a lack of competition in the import, distribution and retail sectors".[1]

1.5 The terms of reference given by the Tánaiste for the study are as follows. To examine:

- How the retail related import/distribution sector operates and how competition works in that sector;
- Whether any practice or method of competition affects the supply and distribution of goods within that sector; and,
- The impact on competition within the sector of direct importation from source countries, rather than indirectly through the UK.

Context

1.6 The *Retail–related Import and Distribution Study* was undertaken by the Competition Authority following a steady increase over the last year in the price differential between the Republic of Ireland ("ROI") and Northern Ireland ("NI"). One effect of the price differential is that ROI consumers have been travelling to NI to purchase groceries and other retail goods.

1.7 The National Consumer Agency ("NCA") published a grocery goods price survey of Tesco, Dunnes Stores and Lidl in the ROI and NI on

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[1] "The Cost of Running Retail Operations in Ireland", Forfás, December 2008 available at http://www.forfas.ie/publication/search.jsp?ft=/publications/2008/Title,2623,en.php.

18th June 2008. The survey found that grocery prices (excluding Value Added Tax ("VAT")) in these supermarkets were on average 21% more expensive in the ROI when compared to NI, with some products having a price differential in excess of 100%. Of the 163 products surveyed, only 27 were cheaper in the ROI. In January 2009, the NCA carried out a survey across 13 stores examining the prices of 44 products across a variety of categories including clothing, homeware, maternity/nursery and electrical goods. The survey found that Irish consumers were being charged an average of 51% more than consumers in the United Kingdom ("UK") of Great Britain ("GB") and Northern Ireland. However, prices were not adjusted to reflect the different VAT rates in the ROI and the UK, nor were Sterling ("STG") values converted into Euro ("EURO").[2] Both surveys were widely reported and picked up on by increasingly informed and more price conscious ROI consumers who questioned why prices were not falling in line with currency movements.

1.8 Retailers in the ROI attributed the price differential to higher business costs south of the border. In response to these claims, the Tánaiste commissioned Forfás to undertake a study into the comparative costs of running retail operations in a number of cities in the ROI and across Europe. Forfás published this study entitled "*The Costs of Running Retail Operations in Ireland*" on the 22nd December 2008. The study examined the composition of retail business costs in the ROI and compared how ROI retailers' cost base compared with retailers in other countries. It found that while operating costs are on average 25% higher in Dublin than in Belfast, they account for a relatively small share of total costs (20-25%), and that therefore higher operating costs in the ROI only added approximately five to six per cent to the total cost of products sold by retailers in Dublin.

1.9 The Forfás study found that while business costs in the ROI were a contributory factor to higher retail prices, the magnitude of the differential could not be justified. The study shifted the public debate away from differences in the cost of doing business as being the sole explanation for price differentials, and retailers were urged to do more to reduce prices.

1.10 The worsening economic situation towards the end of 2008 had an effect on consumer attitudes towards getting value for money. In response to an influx of shoppers from the ROI to the NI border towns such as Enniskillen and Newry, and a number of high profile closures of supermarkets in ROI border towns including Superquinn in Dundalk, the Joint Oireachtas Committee on Enterprise, Trade and Employment ("the Committee") announced that they were undertaking an analysis of the retail sector.

1.11 Through a series of meetings with representatives from the retail trade the Committee would examine the wider retail market throughout the ROI and try to determine why consumers in the ROI are being charged more than consumers in the UK. In these meetings, some retailers cited the costs associated with suppliers as opposed to the cost of doing business as the source of the price differential. The retailers claimed that a substantial portion of the price differential could be explained by the fact that suppliers in the STG zone would not pass on exchange rate benefits. For example Mr. Cormac Tobin from Unicare pharmacies stated that "*We approached our supply base late last year and informed distributors here that we were seeking price reductions*

[2] At the time STG and EURO were close to parity.

on goods manufactured in the UK. The exchange rate relating to sterling had changed at that point and we stated that such price reductions were required. Only one company offered to reduce prices and we arrived at a fair deal with it. We did not receive the same response from other companies".[3]

1.12 Subsequent to these new explanations by retailers for the persistent price differential, alongside the results of the Forfás report and their recommendation that a review of competition in the retail-related import/distribution sector should be undertaken, the Tánaiste made the request to the Competition Authority to undertake this study.

Methodology

Scope of the Tánaiste's Request

1.13 The Tánaiste requested that the Competition Authority study the "*retail-related import/distribution sector*". To undertake this task the Competition Authority had to examine the two distinct levels of the sector: the retail level and the supply level (i.e., the supply chain associated with each of the retail sectors).

1.14 The Competition Authority interprets the retail sector to be the sale and purchase of consumer goods. The Consumer Price Index ("CPI") is used as a starting point for assessing the breadth of the consumer retailing sector. The CPI covers over 1,000 different varieties of goods and services which can be divided into 12 categories of consumer goods. The list below details the CPI categories:

i. Food and Non Alcoholic Beverages;

ii. Alcoholic Beverages and Tobacco;

iii. Clothing and Footwear;

iv. Housing and Water;

v. Electricity;

vi. Gas and Other Fuels;

vii. Furnishings;

viii. Household Equipment and Routine Household Maintenance,

ix. Health (e.g., Pharmaceutical Products);

x. Transport (e.g., Automotive Spare Parts and Accessories);

xi. Communications, Recreation and Culture;

xii. Miscellaneous Goods and Services (e.g., Personal Care, Personal Goods).

1.15 Given the time-frame for completion of the Report, the Competition Authority did not analyse all of these categories.

Narrowing the Scope of the Report

1.16 The Competition Authority progressively narrowed the scope of the study by employing a number of criteria designed to maximise the value of the Report.

[3] Parliamentary Debates (Official Report - Unrevised) Joint Committee on Enterprise, Trade and Employment Wednesday, 4th February 2009; Mr Cormac Tobin, Unicare Pharmacies, appearing with Retail Excellence Ireland.

1.17 To do this a two-stage approach was adopted. The first stage involved applying the following two criteria:

- Level of existing knowledge within the Competition Authority; and,
- Level of public interest/focus of public debate.

1.18 Due to the short timeline for the completion of this Report it was necessary, in as far as possible, to build on existing in-house knowledge. Information was drawn from the Competition Authority's previous analyses of groceries, alcoholic beverages, fuels and lubricants, pharmaceuticals, motor vehicles and newspapers and periodicals. The Competition Authority has built up a substantial amount of knowledge of these product categories through the course of its work, primarily while undertaking the *Grocery Monitor* Reports, merger analyses and assisting European Commission enquiries.

1.19 On 26th February 2009, the Competition Authority published a notice calling for submissions from interested parties and the general public in relation to the import/distribution study in order to focus the report towards categories that had the most public interest. In total, 119 submissions were received, with the majority of these coming from grocery retailers. The Competition Authority also met with a number of representative organisations, retailers and suppliers in order to get their insights into how the retail-related import/distribution sector operates. This stage of the process narrowed the Report's focus to eight categories. These were; groceries, clothing, alcoholic beverages, household appliances, pharmaceutical products, motor vehicles, fuels and lubricants, and newspapers and periodicals.

1.20 The second set of selection criteria, which allowed the Competition Authority to focus on consumer products on which consumers spend most and cannot avoid purchasing, were then applied. The second stage criteria were:

- The magnitude of consumer spend on the product category; and,
- The discretionary nature of the consumption of the product category.

1.21 The Central Statistics Office ("CSO") Retail Sales Index ("RSI") provides a monthly indicator of economic activity in Ireland. It provides a measure of retail trading and is a valuable guide to consumer spending behaviour in the retail market in the ROI. The Competition Authority used this index to assess which categories consumers saw as necessities, which categories consumers were spending most money on and which categories could be excluded from the analysis.

1.22 Based on the above criteria the Competition Authority chose to analyse in more detail three retail sectors:

- Groceries: Groceries include food, non-alcoholic beverages, non-durable household goods and personal care items. Tobacco and alcoholic drinks are not included;
- Clothing: Clothing includes men's and ladies' clothing, children's clothing, sportswear, etc.; it does not include footwear or clothing accessories; and,
- Pharmaceutical Products: This includes prescribed drugs and over the counter (OTC) medication, e.g., antacid, painkillers, cough medicine, vitamins and other supplements.

1.23 Appendix B of this Report outlines in more detail how the above criteria were used to narrow the scope of the analysis of retail-related import and distribution sectors.

Sources of Information

1.24 This Report, and the assessment therein, draws on a number of information sources which can be categorised under three different headings: Internal sources; Domestic (ROI) sources; and, International sources.

1.25 As previously mentioned, the Competition Authority utilised internal knowledge of retail sectors from, among other things, previous studies, merger assessments, and work with the European Commission. This knowledge and information is used throughout the Report and contributes in particular to the analysis of the groceries and pharmaceuticals sectors in Chapters 4 and 6.

1.26 A number of domestic sources of information were also used; these included submissions received, meetings held, surveys and reports of other public agencies, and domestic statistical sources. As already noted, immediately after receiving the Tánaiste's request, the Competition Authority invited interested parties and the general public to make submissions in respect of the Report. A brief summary of the contents of the submissions can be found in Appendix C.

1.27 During the course of the study, the Competition Authority met with 12 retailers, 16 wholesalers/suppliers and 7 representative groups and State agencies. A full list of meetings is included in Appendix D.

1.28 In conducting desk-based research, the Competition Authority drew on a number of domestic sources such as the NCA price surveys, the Forfás report, data from the CSO, the Revenue Commissioners and the Central Bank. Eurostat data were also used.

1.29 In addition, the Competition Authority drew on international sources in three principal ways. First, to depict an accurate picture of the law on supply arrangements and distribution agreements (for an overview of the domestic and EU competition law provisions see Appendix E), the Competition Authority drew on European case law and European Commission guidance documents. Second, the Competition Authority asked other competition agencies in the EU whether they were experiencing, or had experienced, similar cross-border issues in their jurisdiction in response to currency fluctuations; no competition agency reported similar experiences in their country. Third, the Competition Authority examined economic research and literature in relation to currency fluctuations and pass-through, and examined other EU competition authority reports. A report prepared jointly by the competition agencies of the Nordic countries in 2005, entitled *"Nordic Food Markets – a taste of competition"* was the most similar to this Report. That report was undertaken to look at why food prices tend to be higher, and the product range narrower, in Nordic countries compared to some other European countries. The executive summary of this report can be found in Appendix F of this Report.

Aim of the Report

1.30 This Report addresses the terms of reference as set out by the Tánaiste. The Report provides a description of the supply chain, specifically the distribution of imported goods, and how competition works in three important retail sectors – groceries, clothing and pharmaceutical products. As outlined in the previous section, the assessment of these sectors draws from a wide number of sources. With a longer timeframe the Competition Authority could have broadened the scope of the Report, however, the three sectors chosen for analysis are those that have most relevance to the current debate in the ROI as they have a significant weight in terms of consumer spend, and are necessary purchases for consumers.

1.31 The Report was undertaken in substantial part to examine the claim that the source of the price differential that has opened up between retail prices in NI and the ROI is explained by the comparatively higher prices that ROI retailers pay for goods compared with their NI counterparts. The single market initiative and EU competition policy has been designed to prevent the partitioning of national markets – this claim suggests that the EU's policy has had little or no effect in the ROI market.

1.32 At the same time, other claims which were sometimes contradictory were also being made by a number of parties at the outset of this Report, including:

- Many retailers present in the ROI are also present in NI and surely their ROI operations can benefit from the same pricing terms as their NI/UK operations;
- Other retailers present in the ROI are extensively supplied by distribution networks from outside both the EURO and STG zones and presumably their ROI operations are at no competitive disadvantage to their NI/UK operations; and,
- The presence of ROI retailers with buyer power makes it unlikely that the ROI market is distorted by exploitative pricing by suppliers to that market.

1.33 By examining the import/distribution sector of the ROI market, this Report sheds some light on all these factors and how they actually work.

Structure of the Report

1.34 The structure of the remainder of the Report is as follows:

- Chapter 2 considers the price differential that has emerged between the price of consumer goods in the ROI and NI and specifically examines the role that currency movements play in explaining this price differential;
- Chapter 3 considers the interaction of seller and buyer power in chains of supply and the role that these factors play in the context of the current debate surrounding the price differential;
- Chapters 4, 5 and 6 describe, respectively, the supply chains associated with the retail of groceries, clothing and pharmaceutical products in the ROI. These chapters focus on a description of the structure of these supply chains, their linkages with other jurisdictions including the UK, the competitive dynamic present and how operators have responded to the changed economic circumstances; and,
- Chapter 7 concludes with some final commentary.

2. CURRENCY MOVEMENTS AND PRICE DIFFERENTIALS

Introduction

2.1 This chapter considers the price differential that has emerged between the price of consumer goods in the (ROI) and (NI) and specifically examines the role that currency movements play in explaining this price differential. The approach taken is detailed below.

2.2 First, survey evidence on the extent of the price differential is presented. In this context, a distinction is drawn between differences in price levels between the two jurisdictions, which, to some extent, have always been present, as well as changes in the differences in price levels due to currency movements.

2.3 Second, the cost of doing business as an explanation for the price differential is considered. In this regard, the work of Forfás on the differences in the costs of doing business for retailers in the ROI compared to NI is used extensively. As indicated by Forfás, differences in the cost of retailing between the two jurisdictions provide only a partial explanation for the price differential; a substantial portion of the price differential therefore remains unexplained.

2.4 Third, a brief survey of the literature on exchange rate pass-through is presented. The purpose of this review is to assist in the identification of factors relevant to an explanation of why exchange rate pass-through is slow and/or incomplete.

Price Differentials

The NCA Price Surveys

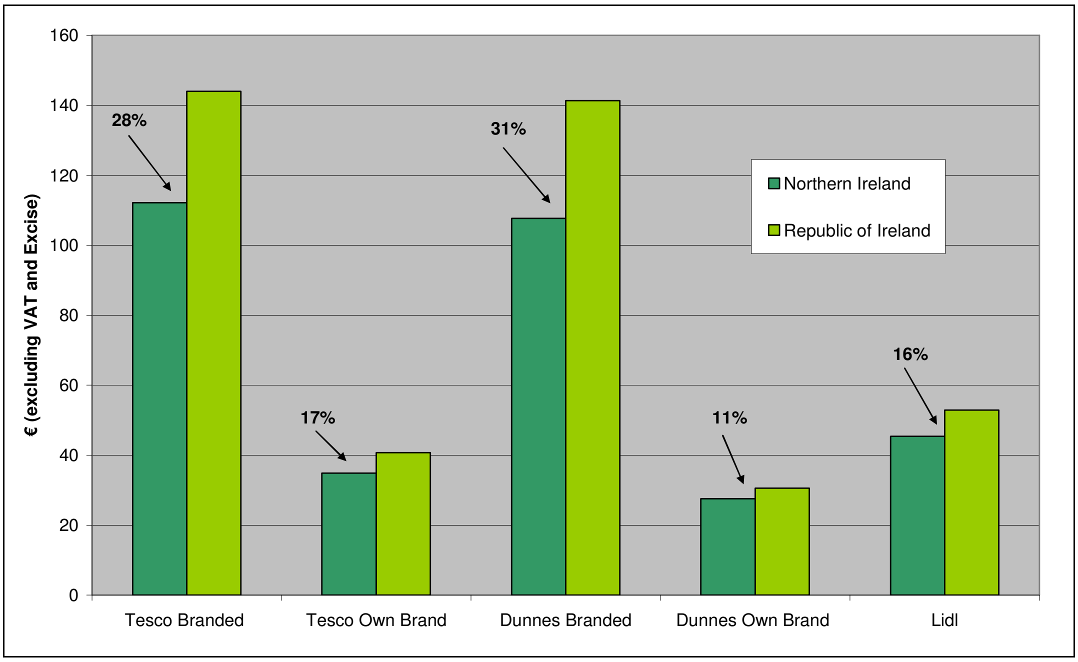
<u>Grocery Price Comparisons</u>

2.5 The NCA conducted a price survey of Tesco, Dunnes Stores and Lidl in the ROI and NI on 4^{th} June 2008. A total of 163 products were surveyed.

2.6 The survey found that prices, excluding VAT, in Tesco, Dunnes Stores and Lidl supermarkets operating in the ROI were, on average, 21% higher than in NI. Branded items were particularly expensive in the ROI; Tesco was 28% more expensive, and Dunnes Stores was 31% more expensive. Compared to NI own branded items in Tesco were 17% more expensive in the ROI, while Dunnes Stores own branded products in the ROI were 11% more expensive. Lidl in the ROI was 16% more expensive compared to NI.

2.7 Table 1 outlines products where the price differential, excluding VAT, between NI and the ROI was highest. The highest price differential was recorded in Lidl stores where the price of a box of McKinleys Tea Bags (80 pack) in NI was €0.40 compared to €0.89 in the ROI – a difference of 123%. Of the 163 products surveyed, only 27 were cheaper in the ROI.

Figure 1: Price Differential between the ROI and NI for Goods Surveyed



Source: NCA Euro/Sterling Survey, basket of goods, 4 June 2008.

Table 1: Biggest Price Differentials between ROI and NI (excluding VAT)

Retailer	Product	NI	ROI	Difference (%)
Tesco	Pedigree Can Loaf Original (400g)	€0.40	€0.77	**93%**
Tesco	McCain Beer Battered Chips (750g)	€1.65	€3.39	**105%**
Dunnes Stores	Barrys Green Label Tea (80 pack)	€1.80	€2.99	**66%**
Dunnes Stores	Colgate Fresh Stripe Total (100g)	€1.66	€2.76	**66%**
Lidl	Golden Sun Long Grain Rice (1kg)	€0.54	€1.09	**102%**
Lidl	McKinleys Tea Bags (80 pack)	€0.40	€0.89	**123%**

Source: NCA Euro/Sterling Survey, 4th June 2008

Non-Grocery Price Comparisons

2.8 In January 2009, the NCA carried out a price survey on a selection of clothing, homeware, maternity/nursing and electrical goods.[4] The survey examined the prices of 44 products across 13 stores. Prices were not adjusted to reflect the different VAT rates in the ROI and the UK, nor did the survey convert STG values into Euro.

[4]The results of this survey are available at : http://www.nca.ie/eng/Media_Zone/Press%20Releases/Survey_shows_prices_higher_in_Republic.html .

2.9 The survey showed that ROI consumers are being charged an average of 51% more than consumers in the UK. For example, an identical dress from retail outlet Monsoon cost £85 in the UK compared to €130 in the ROI.

Usefulness of the NCA Price Surveys

2.10 The NCA surveys are the only sources of information that allow for a comparison of specific grocery and non-grocery items in the ROI and the UK. Unfortunately the surveys do not allow for a comparison of prices over time, while the non-grocery survey did not adjust prices to reflect VAT and exchange rate differences. Further work is needed to allow for a more accurate analysis of price differentials, particularly for non-grocery items.

2.11 Despite these limitations, the surveys point to significant differentials in grocery and non-grocery prices in the ROI and NI/UK.

Price Levels in the ROI and the UK

Changes in Price Levels

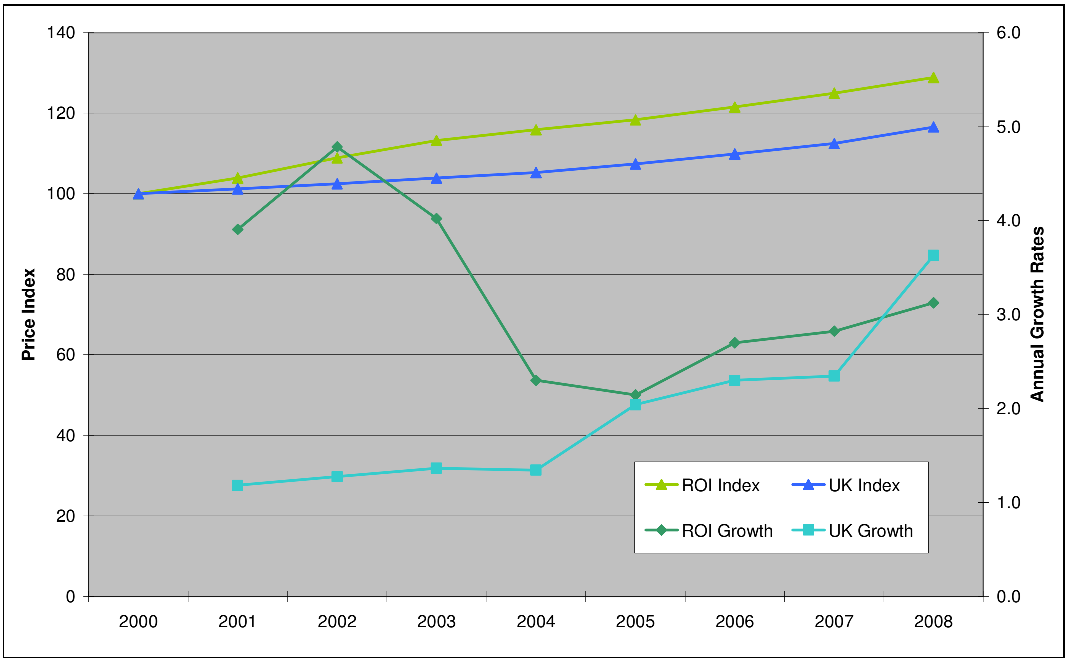
2.12 Consumer prices in the ROI have been increasing at a faster rate compared to the UK/NI for a number of years. This could be expected to lead to a price differential between the two jurisdictions.

2.13 The harmonised index of consumer prices ("HICP") is used to measure the changes in the average price paid for consumer goods and services and provides a common basis for measuring inflation in the EU. Figure 2 below outlines how the HICP index for the ROI and the UK (including NI) has changed on an annual basis between 2000 and 2008. It indicates that average prices in the ROI increased at a faster rate compared to the UK between 2000 and 2008. Prices in the ROI grew at an average rate of 3.2% per annum (or 26% over the eight year period) while the UK index grew by an average of 1.9% per annum (or 15% over the eight year period). However, it is important to note that in 2008, UK price levels grew at a faster rate than in the ROI; during 2008, consumer prices rose by 3.6% in the UK, compared to just 3.1% in the ROI. More recently, ROI price levels for February 2009 were 0.1% higher than in February 2008, whereas UK price levels for the same month were 3.2% higher compared to 2008.

A closer examination of some of the individual categories within the HICP confirms this trend

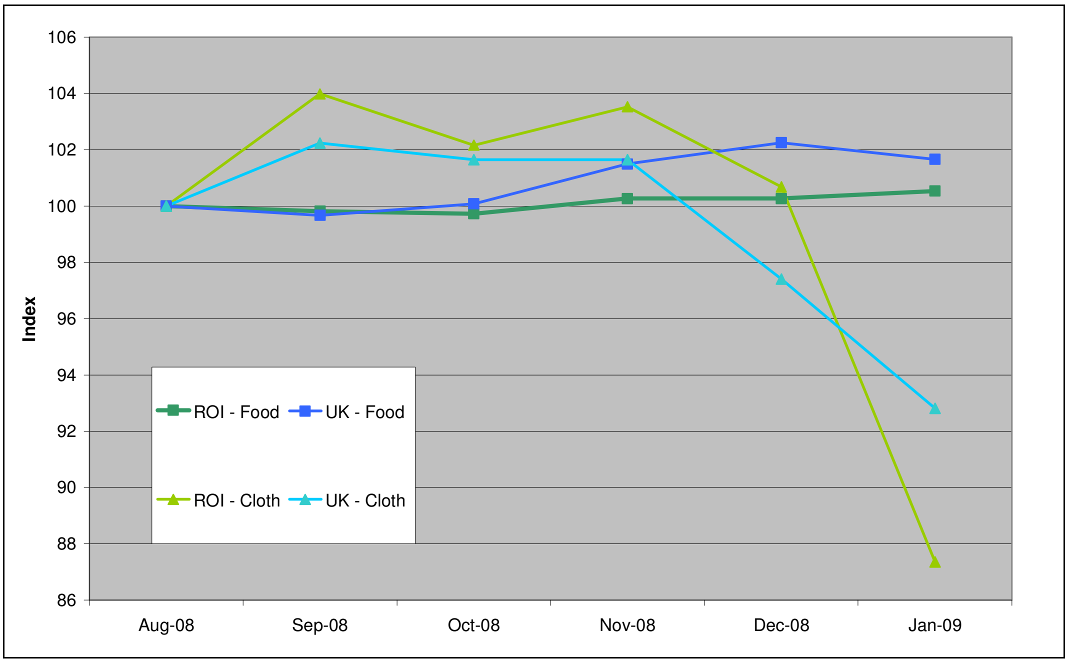
2.14 Figure 3 below shows how food and clothing and footwear prices in the ROI and the UK have been changing on a monthly basis. The most recent comparable data (2008) indicate that the average price of food and non-alcoholic beverages in the UK has been increasing at a faster rate than in the ROI. Moreover, clothing and footwear prices in the ROI have been decreasing at a faster rate than in the UK.

Figure 2: Consumer Prices (HICP) in the ROI and the UK, 2000-2008



Source: Eurostat HICP

Figure 3: Food and Clothing Prices in the ROI and the UK, August 2008 – January 2009



Source: Eurostat HICP

<u>Relative Price Levels</u>

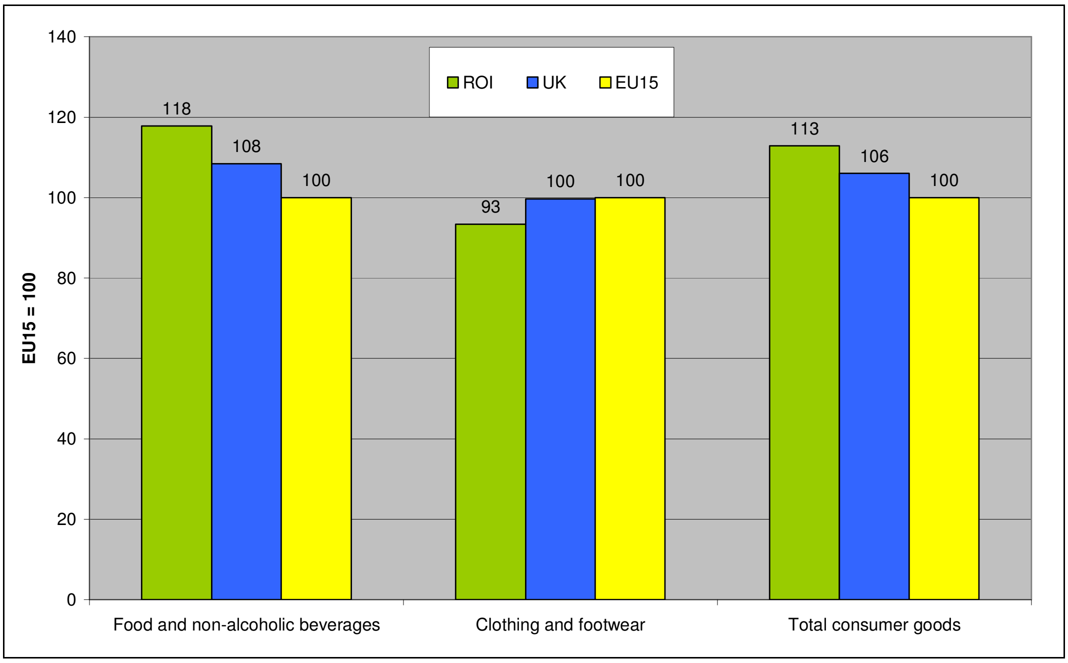
2.15 Price <u>level</u> indices produced by Eurostat allow for a comparison of relative price levels (including taxes) with respect to the EU15 average. The price data are adjusted to account for differences in exchange rates and national currencies. Therefore, they provide a measure of the difference in price levels between countries by indicating the amount of EURO needed to buy the same volume of the product group in each country.

2.16 In 2000, the ROI price level index for all consumer goods was six per cent lower than in the UK; therefore, prices in the ROI were cheaper compared to the UK. Specifically, food was two per cent cheaper in the ROI while clothing and footwear was seven per cent cheaper.

2.17 However, seven years later, in 2007 (the most recent data available), the ROI price level index for all consumer goods was seven per cent higher than in the UK (see Figure 4). Hence, overall consumer prices in the ROI were more expensive than in the UK. In 2007, food was 10% more expensive while clothing and footwear were 7% cheaper in the ROI.

2.18 In comparison to the EU15, during 2007 overall consumer prices (i.e., total consumer goods) and food prices in the ROI were well above the EU15 average (EU15=100), yet clothing and footwear prices remained below the EU average.

Figure 4: Price Level Indices in the ROI and the UK, 2007 (EU15 = 100)



Source: Eurostat

2.19 This indicates that, while the ROI was cheaper than the UK in 2000, sustained annual price increases resulted in ROI price levels surpassing UK levels by 2007. However, in recent months inflationary pressures have eased in the ROI and prices are now rising at a slower rate compared to UK and Eurozone averages.

Factors Contributing to Differences in Price Levels

2.20 There are a number of reasons why consumer price levels between the two jurisdictions will tend to differ under any circumstances.

2.21 The first class of factors are influenced by public policy. The most readily appreciable aspect of the public policy environment in terms of an impact on price differences is VAT. The standard rate of VAT in the

ROI is 21.5%[5] compared to 15% in the UK. This makes many goods and services more expensive to buy in the ROI compared to the UK. However, while many snack foods, confectionery and soft drinks are taxable at either full or reduced rates in the ROI and NI (17.5% in the ROI and five per cent in the UK), most staple foodstuffs such as bread, milk and meat have a zero-rate of VAT in both jurisdictions.

2.22 Other public policy factors include differences in planning conditions at the micro level and monetary policy at the macro level. For example the Irish planning guidelines contain restrictions on where retail outlets may open, and contain an absolute limit on floorspace size. These restrictions limit price competition between retailers; in comparison, the UK planning system is not as restrictive as that in the ROI.

2.23 The ROI, as part of the Eurozone, operates in a different monetary environment to the UK. Consequently, the European Central Bank (ECB) controls interest rates in the ROI while the Bank of England controls UK interest rates. Since 2000, Eurozone interest rates have been lower than UK rates. The lower the interest rate, the cheaper the cost of borrowing money. This tends to increase consumer demand and drives prices up, which partially explains why prices levels in the ROI have been growing at a faster rate than in the UK.

2.24 A second class of factors that lead to different price levels in the two jurisdictions are so-called "demand side factors". Consumer demand increased sharply during the Celtic Tiger period, stimulated by a number of factors including low interest rates, wage increases, almost full employment and higher levels of disposable income.[6] As already mentioned, high consumer demand tends to drive prices up. The ROI average disposable income was 16% higher than in NI, but just over one per cent less than the UK average. In 2004, disposable income in Dublin – a key determinant of consumer demand - was 31% higher than in NI and 12% higher than the UK average. Consumer preferences can also have an impact on price levels. Irish consumers often favour home-grown or Irish produced goods (i.e., Irish meat, vegetables, biscuits etc.) from small-scale domestic operations where business costs, and thus prices, are likely to be higher compared to larger scale UK or European operations that benefit from greater economies of scale.

2.25 The third class of factors that lead to different price levels in the two jurisdictions are supply side factors. As an island nation on the edge of continental Europe, the cost of transporting goods across the Irish Sea means that prices in the ROI may be higher compared to the UK. Moreover, a comparatively poor road network and a dispersed population, coupled with the fact that some major ROI retailers do not yet operate central distribution systems, means that transport costs are likely to be higher within the ROI.

2.26 While NI stores must also transport goods across the Irish Sea, the NI market is serviced by a greater number of large UK retailers, many of whom regard NI stores as being the same as any other UK store, with the result that they are often willing to offset any transport costs in order to keep prices the same across all UK stores (see Chapters 6 and 7). This also means that NI benefits to a greater degree from economies of scale, centralised distribution systems and stronger linkages with the STG zone. Nonetheless, many of the retailers that are present in NI are also present in the ROI and should, in principle,

[5] The standard rate of VAT was raised from 21% to 21.5% in the October 2008 budget.
[6] Disposable income refers to take-home pay after taxation.

be able to benefit from scale economies in the UK. The degree to which this is true depends upon the extent to which the ROI operations of these retailers are integrated with UK operations.

The Impact of Currency Movements

2.27 Relative price level data adjusted for currency movements revealed that consumer prices in the ROI were higher than those in the UK/NI in 2007 (see paragraph 2.17 above). Total consumer goods were seven per cent more expensive in the ROI while food was 10% more expensive. As indicated, there are a variety of reasons why price levels in the ROI might be higher than in the UK.

2.28 It is important that these reasons are distinguished from the effect that recent EURO/STG currency movements have had when comparing price differentials. The strengthening of the EURO versus STG has widened the price differential further. According to the NCA, on average the price differential between the ROI and the UK/NI is now approximately 21% and can be as high as 31%.

2.29 How can this widening of price differentials be explained? Retailers have argued that higher operating costs explain much of the price differential. Retailers have also argued that wholesalers and distributors have been slow to pass on savings arising from currency movements in recent times. These and a number of other issues are explored in the following section.

The Cost of Doing Business

The Cost of Running Retail Operations in Ireland

The Forfás Report

2.30 At the request of the Tánaiste and Minster for Enterprise, Trade and Employment, Forfás examined the comparative costs of running retail operations in a number of cities in the ROI, the UK and the Netherlands. The purpose of the study, entitled "*The Costs of Running Retail Operations in Ireland*", which was published in December 2008, was to examine the composition of retail business costs in the ROI and to determine how their cost base compares with retailers in other countries. Retail sector interests have argued that prices in the ROI are higher because the cost of doing business in the ROI is higher compared to other locations.

2.31 To understand the cost structure of firms in each of the retail sectors (i.e., the percentage of costs which are labour or property related), a range of foreign and ROI-owned retailers based in the ROI were surveyed. Four broad retail formats were addressed in the Report (convenience, multiple, department stores and retail park). Unit cost data (e.g., the cost of labour or property in a city) was then collected for four ROI and four international cities. Based on the cost profiles and the unit cost data, company profiles were developed that combine these data to provide an overview of the cost competitiveness of a retailer operating in the ROI relative to comparator locations.

2.32 Based on the surveys, the cost of buying goods for resale is the single biggest cost incurred by retailers and accounts for 75-80% of their total costs. The operating costs, i.e., those costs expended in bringing these goods to customers (labour, property, utilities, etc), account for 20-25% of their total costs.

Operating Cost Structure

2.33 Operating costs are predominantly comprised of labour costs, property costs, transport costs and utilities. Other services including security, cleaning, advertising and marketing, and professional services can also be significant for individual retailers. Based on surveys, operating costs can be broken down for various types of retailers as shown in Table 2 below.

Table 2: Operating Cost Profiles by Retail Format (excluding the costs of goods)

Costs	Convenience	Multiple	Department Store	Retail Park
Labour Costs	54%	37%-60%	46%-49%	32%-35%
Property Costs	32%	16%-18%	25%-28%	26%-29%
Transport and Distribution	-	1%-18%	0%-2%	9%-24%
Utilities	11%	6%-9%	3%-5%	4%
Security and Cleaning	1%	3%	3%-5%	2%-3%
Advertising and Marketing	-	4%-8%	3%-4%	5%-10%
Local Authority Rates	-	1%-2%	3%-4%	3%-4%
Other Business Services	2%	4%-10%	10%	3%-7%
Total Operating Costs	100%	100%	100%	100%

Source: Forfás, December 2008

Unit Cost Data

2.34 Labour costs account for the largest share of total operating costs followed by property costs, transport and distribution, utilities and other costs. Unit costs (i.e., labour costs) in Dublin are generally comparable to those in London but higher than those in either Belfast or Manchester, while costs are more competitive in other cities in the ROI.

Relative Cost Competitiveness of Retail Operations in ROI

2.35 Table 3 summarises the variance in costs between the various case study retail stores that were surveyed in the ROI and the UK. This table sets out the cost differential of operating an identical store across four other cities compared to Dublin. A negative number (denoted by parentheses) indicates that the relevant city has a cost advantage over Dublin. For example, the cost of operating a convenience store in Manchester is 25% lower than that in Dublin (excluding the cost of goods).

Table 3: Summary of Variance: Dublin versus Comparator Cities

Costs	Belfast	London	Manchester	Galway
Convenience	(46%)	22%	(25%)	(27%)
Multiple Stores	(32%) – (13%)	4% - 5%	(23%) – (7%)	(18%) - (8%)
Department Store	(34%) – (19%)	(4%) - 5%	(31%) - (25%)	(27%) – (23%)
Retail Park Store	(21%) – (18%)	6% - 8%	(14%) – (11%)	(12%) – (7%)

Source: Forfás, December 2008

2.36 On average, operating costs in Dublin are 25% higher than those in Belfast. These operating costs increase the total cost of doing business in Dublin and account for approximately 20-25% of the total cost of running retail operations – the remaining costs are principally accounted for by the cost of goods. Therefore, higher operating costs add approximately 5-6% to the total cost base of retailers in Dublin versus those operating in Belfast. Other ROI cities are relatively more cost competitive.

The Cost of Doing Business as an Explanation of the Price Differential

2.37 The Forfás report is based on a number of key assumptions that are clearly outlined at the beginning of the report. For example, the report assumes the same cost structure in the benchmarked countries. Moreover, the report also uses exchange rates from October 2008 (€1=£0.79). The EURO has strengthened considerably since then, with the result that cost differentials between the ROI and NI are likely to be greater than originally reported by Forfás.

2.38 The NCA survey suggests that the price differential between the ROI and NI for grocery items is about 21%. The Forfás report examines only the cost of running retail operations in the ROI and finds that the cost of doing business would only account for a five to six per cent price differential with NI. However, because of the effect that the cost of doing business has on the cost of the product, via its influence on importation and distribution costs (i.e., transport, warehousing, associated labour costs as well as sales and marketing costs), the Forfás report probably underestimates the impact of the cost of doing business on price differentials. Quantification of this additional factor is beyond the scope of this Report.

2.39 However, the magnitude of this effect would depend crucially on the precise supply route that a retailer opts for. Specifically, the effect is likely to be greater for retailers that utilise ROI distribution channels, such as local offices of international companies, agents and third party distributors located in the ROI. Indeed, a number of retailers have indicated that this consideration is one reason why they are beginning to seek more direct linkages with the UK.

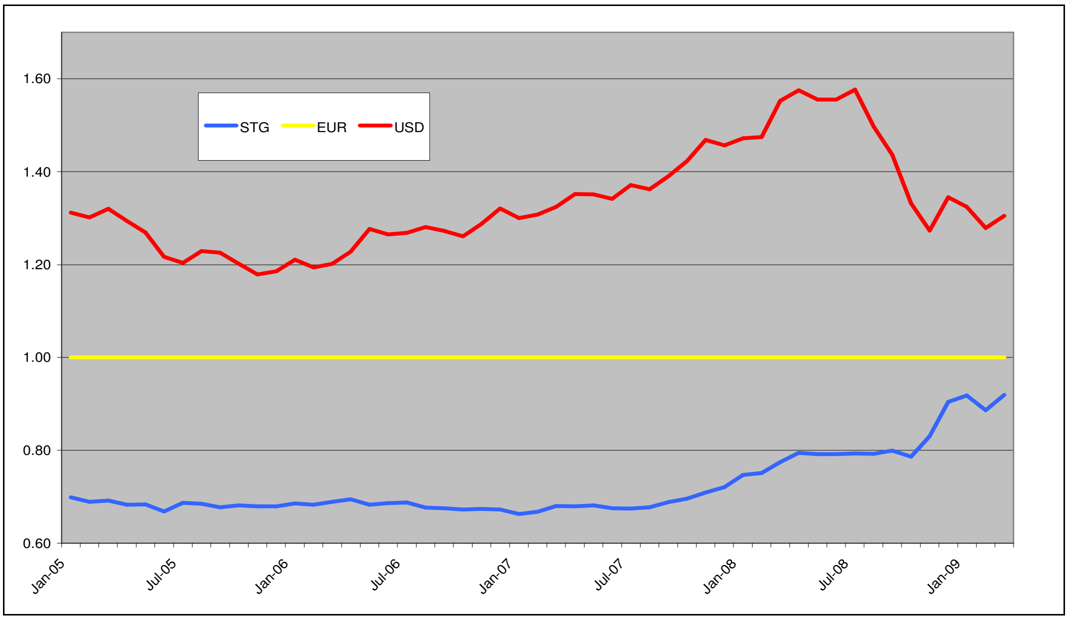
Exchange Rate Pass Through

2.40 If the value of the EURO versus STG strengthens, this makes it cheaper for importers in the ROI to purchase goods and services from the UK and NI. In theory, savings made through currency movements could be passed on to consumers through lower prices. This should in theory moderate the price differential in consumer prices between the ROI and the UK/NI.

Currency Movements and Potential Pass-through

2.41 The value of the EURO versus STG has strengthened in recent years. As Figure 5 illustrates, the EURO/STG rate remained at a relatively consistent level over the period from January 2005 to the end of 2007. During this period €1 was worth between £0.66 and £0.69. The value of the EURO then rose sharply until April 2008 when €1 was worth £0.79. The EURO/STG rate remained at this level until November 2008 when the EURO rose sharply again. In March 2009, €1 was worth £0.92.

Figure 5: Value of the EURO versus the STG and the US Dollar

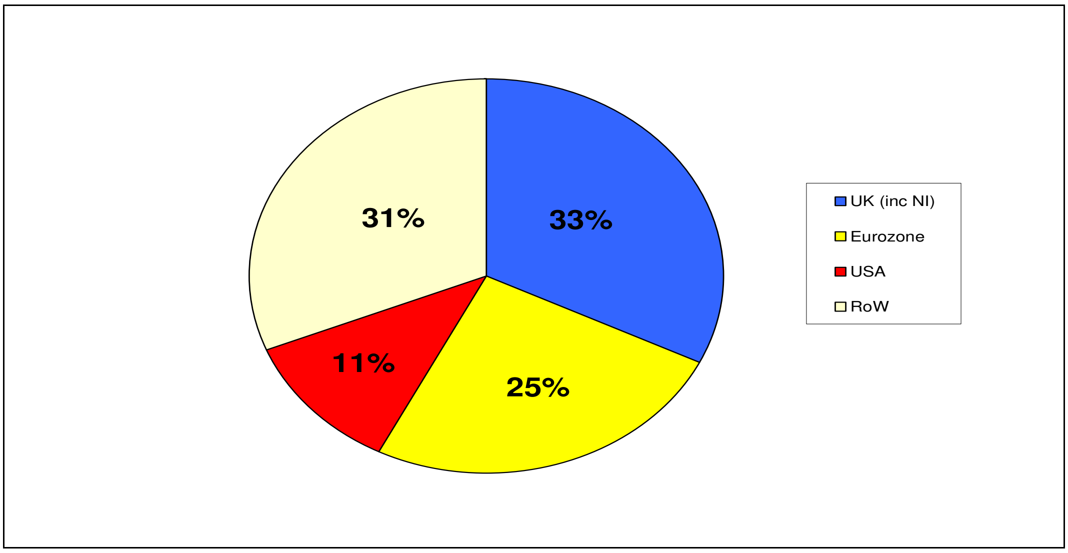


Source: Central Bank

2.42 The UK (including NI) is the ROI's most significant trading partner. Therefore, recent currency movements can potentially lower consumer prices. In 2007, 32% of ROI imports (in value) were from the UK (see Figure 6). Almost 50% of the value of food, live animals, beverages and tobacco imports comes from the UK. Similarly, almost 50% of manufactured goods are imported from the UK.

2.43 This suggests that substantial savings are available if exchange rate pass-through were complete. One limiting factor on this effect is the extent to which items manufactured in the STG zone have costs arising in the eurozone (or indeed other currency zones). This is discussed in more detail below.

Figure 6: Imports from STG, Dollar, EURO regions and the Rest of the World, 2007.



Source: CSO External Trade Statistics

History of Exchange Rate Pass-through

2.44 The value of the EURO versus STG has grown, making it cheaper for retailers in the ROI to import goods from the UK, a key trading partner to the ROI. It would be expected that lower import prices would lead to lower consumer prices. For example, say a retailer has a cost profile of 20% operating costs and 80% cost of goods. Assuming all 80% is sourced in the UK and all input costs for the manufacturers are STG costs, a 10% depreciation of STG means a potential eight per cent reduction in consumer prices.

2.45 Does it always follow that the full savings will be passed on to the consumer? Literature on exchange rate pass-through considers the extent to which exchange rate movements are passed through to traded good prices, as opposed to being absorbed into producer profit margins or mark-ups. In summary, the literature indicates that a 10% appreciation of the EURO does not guarantee a 10% fall in import prices; a certain amount is usually absorbed into producer profit margins or mark-ups. Therefore, exchange rate pass-through is typically neither immediate nor complete.

2.46 Campa, Goldberg and Gonzalez-Minguez (2005) examined exchange rate pass-through to import prices in the EURO area. Their estimates which, are based on data covering the period 1990-2005, suggest that average pass-through rates in the EURO area are 0.66 in the short-run (three months) and 0.80 in the long-run. Therefore, in the long-run, a 10% appreciation of the EURO will lead to an eight per cent fall in import prices. The pass-through rate estimates for the ROI are lower; in the short-run rates are 0.50 while the long-run rate is only slightly greater at 0.56.

2.47 Research by Campa and Goldberg (2005) for OECD countries found average pass-through rates of 0.46 in the short-run and 0.64 in the long-run. Anderton (2003), using a different approach, estimates an average long-run exchange rate pass-through between 0.50 and 0.70 for the aggregate manufacturing sector in the euro area.

2.48 The European Central Bank (2003) suggests that the pass-through of changes in the effective exchange rate of the EURO to extra-EURO area imports (i.e., outside the Eurozone) of manufactures is around 0.50 - 0.70 in the long-run.

Table 4: Exchange Rate Pass-through Elasticities

Source	Short-run	Long-run
Campa, Goldberg, Gonzalez-Minguez (2005) – EURO	0.66	0.80
Campa, Goldberg, Gonzalez-Minguez (2005) – IRL	0.50	0.56
Campa and Goldberg (2005) - All OECD	0.46	0.64
Campa and Goldberg (2005) - EURO	0.47	0.70
Anderton (2003) – EURO	0.50	0.70
European Central Bank (2003) – Extra-EURO	-	0.50 - 0.70

Source: Table produced by the Competition Authority using various sources.

Factors Leading to Slow and/or Incomplete Pass-through

2.49 As described above, the average exchange rate pass-through ranges between about 0.50 and 0.65 in the short-run and 0.65 and 0.80 in the long-run. It is unlikely that the pass-through rate will ever be one (i.e., complete). The economic literature has highlighted some key explanatory factors, macroeconomic factors and microeconomic factors, to explain why this is.

Macroeconomic Factors

2.50 Three main macroeconomic factors are distinguished in the literature:

- The rate of inflation and institutional response;
- The effect of the Eurozone and,
- Slowly adjusting prices.

2.51 A popularly held view is that exchange rate appreciation lowers inflation while exchange rate depreciation increases inflation. While this does frequently occur in unstable monetary environments, the correlation between exchange rates and consumer price inflation has been in decline in recent decades due to stablility objectives pursued by monetary policy authorities. Expectations of inflation are more consistent and rigidly anchored (e.g., at two per cent annually). Therefore, if there is an economic shock, for example if exchange rates or energy prices move substantially, monetary policy authorities will attempt to counter the effect by using instruments of monetary policy, chiefly interest rates, and keep inflation levels at a consistent level. However, the ROI as part of the Eurozone has no control over domestic interest rates. Therefore, when the EURO appreciates versus STG, the potential for pass-through will be determined externally via the Eurozone interest rate.

2.52 The creation of the Eurozone has resulted in a higher proportion of trade being done in EURO. Thus a smaller proportion of industry output is exposed to exchange rate fluctuations associated with non-euro area countries. While a large percentage of ROI imports are extra-EURO, more so than other EU countries, the share of imports from within the Eurozone has been growing. In 2007, 25% of ROI imports came from within the Eurozone. As a result, the potential for exchange rate pass-through is reduced.

2.53 A key determinant of low exchange rate pass-through is the slow adjustment of prices, or so called "sticky" prices. For example, if the EURO appreciates significantly, UK exporters are likely to hold prices constant for a period of time until importers or retailers in the ROI start putting pressure on them to lower their export prices. The lack of scale and buying power of some ROI retailers also means that their ability to pressurise exporters is diminished somewhat. The outcome is that it will take some time for ROI price levels to fall as a result of changes in currency movements.

<u>Microeconomic Factors</u>

2.54 The economic literature indicates that exchange rate pass-through is more heavily influenced by microeconomic factors. The three key microeconomic factors outlined are as follows:

- Pricing to market;
- Hedging[7] of currency risk and denomination of supply contracts; and,
- Composition of imports.

2.55 The fact that exporters frequently appear to "price-to-market" provides one key explanation for incomplete pass-through of import prices. The ECB research indicates that when exporters outside the Eurozone are exporting to a country inside the Eurozone, the price they decide to charge is weighted by exchange rate movements (50-70%) followed by pricing-to-market (30-50%). This means that exporters will vary their desired mark-up over marginal cost across different markets depending on the elasticity of demand they face. For example, UK exporters are fully aware of the strong position that ROI importers are in due to the EURO/STG exchange rate and will price (higher) accordingly; UK exporters would have also been aware of strong consumer demand and high disposable incomes in the ROI when setting import prices. UK exporters may also have been aware that the level of competition in the ROI market is not as strong compared to the UK/NI where there is a greater number of large-scale retailers. ROI retailers and importers may decide to switch suppliers where this occurs, however, their ability to switch quickly often depends on logistical factors and the availability of alternative sources.

2.56 Similarly to the above, exporting firms will often set prices in the currency of the country to which they export. Therefore, exchange rate fluctuations will have less impact on import prices, at least in the short-run. UK exporters to the ROI may have been setting the price of their goods in EURO due to the strengthening of the EURO versus STG.

2.57 An alternative explanation for changes on exchange rate pass-through into aggregate import prices may be the changes that have occurred in the composition of country imports. If a country shifts the content of its trade from industries with high pass-through elasticities into industries with lower demand elasticities, the country's aggregate

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[7] To 'hedge' is a position established in one market in an attempt to offset exposure to the price risk of an equal but opposite obligation or position in another market.

pass-through elasticities will decline. Pass-through rates vary depending on what is being imported. For example, pass-through rates are higher, or closer to one, for homogenous goods like oil compared to consumer or manufactured goods. In the past imports of energy made up a larger percentage of total imports for most countries, therefore pass-through rates were very high. However, in recent times, manufacturing imports, or goods that are less homogenous, have grown in importance, meaning that pass-through rates have fallen. The ROI imports fewer homogenous products like oils, mineral fuels and other crude materials compared to other EU countries which partially explains why the ROI pass-through rates are quite low compared to other EU Member States.

2.58 Finally, another limiting factor on exchange rate pass-through is the extent to which items manufactured in the STG zone have costs arising in the Eurozone (or indeed other currency zones). UK manufacturers frequently sell most of their produce in the STG zone but purchase raw materials in EURO. For example, a UK food manufacturer might purchase all or some of its wheat from Italy. With the depreciation of STG relative to the EURO, the cost base of many UK manufacturers has grown, and with it their ability to pass on savings to ROI importers.

<u>Comment on Incomplete pass-through</u>

2.59 Retailers in the ROI have argued that wholesalers and distributors have been slow in passing on savings arising from currency movements in recent times. Indeed the analysis has highlighted a number or reasons why pass-through rates are likely to be slow and/or incomplete:

- 25% of ROI imports are sourced from within the Eurozone;
- Pass-through rates are higher for homogenous goods (i.e., oils and crude materials): the ROI imports a very small amount of homogenous goods;
- UK exporters are aware of ROI importers' strong position due to the exchange rate and they price accordingly;
- UK manufacturers and exporters must frequently purchase raw materials in EURO; and,
- Prices are usually sticky or slow to adjust downwards.

2.60 It is unlikely that the pass-through rate will ever be one. Some of the factors outlined above are likely to have long-term impacts on pass-through rates, for example, the nature of ROI trade in terms of the composition of imports and trading partners. However, other influencing factors (i.e., the fact that exporters price-to-market) are likely to diminish over time as ROI importers pressurise UK suppliers to reduce their export prices.

Concluding Comment

2.61 The NCA conducted a price survey of Tesco, Dunnes and Lidl in the ROI and NI on the 4th June 2008. The survey found that prices, excluding VAT, in Tesco, Dunnes Stores and Lidl supermarkets operating in the ROI were on average 21% higher than in NI, and can be as high as 31%.

2.62 Consumer prices in the ROI have been increasing as a faster rate compared to the UK (including NI) for a number of years. Between 2000 and 2008 prices in the ROI grew at an average rate of 3.2% per annum while UK prices grew by an average of 1.9%. As a result, in 2007 the ROI price level index for all consumer goods was seven per cent higher compared to the UK. Hence, overall consumer prices in the ROI were more expensive compared to the UK.

2.63 There are a number of reasons why consumer price levels between the two jurisdictions will tend to be different under any circumstance; these include differences in the regulatory environment, planning conditions and demand and supply side factors.

2.64 Retailers have argued that higher operating costs go a long way towards explaining the differential. The Forfás Report found that higher operating costs add approximately five to six per cent to the total cost base of retailers in Dublin compared to those operating in Belfast. Other ROI cities are relatively more cost competitive. However, because of the effect that the cost of doing business has on the cost of the product, via its influence on importation and distribution costs, the Forfás report probably underestimates the impact of the cost of doing business on price differentials.

2.65 Retailers have also argued that wholesalers and distributors have been slow in passing on savings arising from currency movements in recent times. Literature on exchange rate pass-through considers the extent to which exchange rate movements are passed through into traded good prices, as opposed to being absorbed into producer profit margins or mark-ups. The literature indicates that a 10% appreciation of the EURO does not guarantee a 10% fall in import prices; a certain amount is usually absorbed into producer margins or mark-ups. Therefore, exchange rate pass-through is typically neither immediate nor complete. There are a number of micro and macroeconomic factors that explain why this is the case. Some of these factors will have long-lasting effects on pass-through rates while others are likely to have short-term effects.

2.66 It is important to note that in recent months inflationary pressures have eased in the ROI and prices are now rising at a slower rate compared to the UK.[8] In 2008, UK consumer prices rose by 3.6% compared to 3.1% in the ROI. More recently, ROI price levels for February 2009 were 0.1% higher compared to February 2008 whereas UK price levels for the same month were 3.2% higher compared to 2008.

[8] The most recent CPI figures indicate that prices in March 2009 fell by 2.6% compared to March 2008. However the CPI index, unlike the HICP Index, captures mortgage payments which have fallen significantly in recent months.

3. MARKET POWER IN CHAINS OF DISTRIBUTION

Introduction

3.1 As part of the public debate surrounding the reasonableness or otherwise of the price of consumer retail products in the ROI, compared to similar products in NI, concerns have emerged that retailers in the ROI may be abusing their buying strength vis-à-vis suppliers. If ROI retailers have buyer power, then that would reduce the likelihood that the ROI market is distorted by exploitative pricing by suppliers and would undermine arguments that suppliers are the source of the ROI/NI price differential.

3.2 One sector where certain operators are likely to have a degree of buyer power is the retail grocery sector, which has become more concentrated over the last number of decades. The Competition Authority's *Grocery Monitor* Report No. 1 found that just three wholesalers/retailers control around half of the volume of groceries consumed in the ROI. This level of concentration is substantial and indicates that these three operators are likely to have a degree of buyer power. Whether buyer power is good or bad for consumers depends largely on the nature of competition at the retail level of the supply chain. The purpose of this section is to examine the concepts of seller and buyer power and the consequences of their interaction in a supply chain.

3.3 Competition concerns rarely arise in markets where there are many sellers and buyers. As markets become more concentrated, either on the demand side or the supply side, the intensity of competition may weaken. Two classes of market power can therefore be distinguished; seller power and buyer power. Seller power may arise where there are few sellers in a market, while buyer power may arise where there are few buyers. In a chain of distribution, both situations may arise simultaneously, that is, few sellers selling to few buyers.

3.4 The approach taken for this discussion of seller and buyer is as follows. First, an overview of seller power is provided. When does seller power arise, what factors point toward the existence of seller power and what are its consequences? When considering seller power, the key question is; when does seller power become a problem? In this context, the economic concept of substantial market power is examined alongside its legal counterpart of dominance.

3.5 Second, an overview of buyer power is provided. Again, when does buyer power arise, what factors point toward the existence of buyer power and what are its consequences?

3.6 Third, the interaction of seller power and buyer power in a chain of distribution is considered. As already noted, markets characterised by many sellers and many buyers rarely raise concerns. However, in a chain of distribution the situation where there are few sellers and/or few buyers may arise. In such a situation, the net effect on final consumers is examined.

3.7 Finally, the chapter concludes with a comment on certain apparently incongruous aspects of the recent public debate. On the one hand, retailers have been the focus of criticism over the price differential that has emerged between the ROI and NI. On the other hand, retailers have also received some criticism over their treatment of suppliers and specifically for seeking reductions in the net price of products that they resell. The challenge from a public policy and competition law enforcement perspective is to discern legitimate actions by retailers, and indeed suppliers, from illegitimate ones. The Competition (Amendment) Act 2006 and the Competition Act 2002 are there to prevent abusive actions by retailers or suppliers. However specific instances of possible abuse will not be discussed in this Report as these are enforcement matters (for further disussion of the law relating to distribution chains see Appendix E).

Seller Power

What is Seller Power?

3.8 Seller power is a form of market power that a seller (e.g., a supplier) is able to exert over those who buy its goods or services. Such power may arise where buyers consider it important for their business that they buy a particular good or service supplied by the seller and where the buyers cannot source such supplies of similar or substitutable goods or services from another supplier currently or in the near future.

When is Seller Power Problematic?

3.9 The market power enjoyed by a seller becomes problematic when that power is so substantial that the seller is considered to have a dominant position in the relevant market and when the seller's actions constitute an abuse of its position.

3.10 Most players in a market, whether they are sellers or buyers, are constrained in the actions they take by the actions and reactions of competitors and customers. However, where such competitive constraints are not sufficiently effective, a supplier/seller may enjoy substantial market power. The longer the time period over which this power is maintained, the greater the chance that the supplier/seller could be proven to be dominant in the relevant market. Legally dominance has been defined as "*a position of economic strength*" enjoyed by an "*undertaking*"[9] which enables it to prevent effective competition being maintained on a relevant market, by affording it "*the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers*".

3.11 The assessment of dominance is based on the competitive structure of the market and, in particular, the following factors are taken into account:

- the market position (in terms of market share, etc.) of the allegedly dominant undertaking and its actual competitors;
- the constraints imposed by the credible threat of future expansion by actual competitors or entry by potential competitors; and
- the constraints imposed by the bargaining strength of the undertaking's customers, referred to as "*countervailing buyer power*".

3.12 While being dominant is not in and of itself illegal, the aim of competition law is to ensure that a dominant undertaking does not exclude its rivals by means other than competing on the merits of the products or services it provides. In other words, competition law seeks

[9] "Undertaking" is the legal term used in Irish and European competition law for the various types of businesses and organisations that are subject to competition law.

to ensure that when businesses fail it is as a result of their own actions, products and circumstances and not as a direct result of the behaviour of a dominant rival. Therefore, it is the <u>abuse</u> of a dominant position that is prohibited by competition law. It is considered that the abuses that are most harmful to consumers are those which (attempt to) exclude competitors from the market. Examples of exclusionary abuses include where a seller:

i. uses an exclusive purchasing obligation or has a certain stocking requirement that obligates a buyer to purchase exclusively or to a large extent only from that seller; or

ii. requires a buyer that purchases one of its products to also purchase another product, effectively "tying" the two products together.

3.13 Each abuse of dominance allegation has to be assessed on a case-by-case basis (for further discussion of the types of abuses of dominance that can arise in supply chains see Appendix E).

Indicators of Substantial Market Power and Dominance

3.14 In general, if a seller has a market share below 40 percent, if its existing competitors could expand within a reasonable time frame, if potential competitors could enter the market, and/or if there is strong countervailing buyer power, then it is unlikely that the seller would be considered to have a dominant position in the market.[10] So dominance is assessed in light of the relevant market conditions, i.e., on a case-by-case basis taking account of the dynamics of the market and the extent to which products are differentiated.

Comment

3.15 As noted above, constraints imposed by the bargaining strength of buyers is one of the factors that mitigates against a finding of a seller having substantial market power or being dominant. Therefore, the next section discusses the issue of countervailing buyer power.

Buyer Power

What is Buyer Power?

3.16 Buyer power is a form of market power that a customer (e.g., a retailer) is able to exercise against its suppliers. A retailer with significant buyer power will be in a better position to obtain more favourable trading terms from its suppliers than a retailer with no buyer power. A supplier is likely to earn a smaller profit margin on goods sold to a retailer with buyer power than those sold to a customer with no buyer power. By definition, the supplier will typically earn a smaller margin but sell more of its goods to the retailer with buyer power.

3.17 Buyer power is more likely to occur in a market with many sellers but few buyers.[11] In this case, many sellers compete against each other to sell their products to a limited number of large and sophisticated

[10] *Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings.* This may be accessed at http://ec.europa.eu/competition/antitrust/art82/index.html.

[11] This is sometimes referred to as an oligopsony market.

buyers. One source of buyer power is the ability to credibly threaten to switch, within a reasonable time frame, to alternative suppliers or to engage in self-supply (i.e., vertically integrate backwards and become a supplier itself) in response to a price rise by the supplier.

Indicators of Buyer Power

3.18 Determining the precise degree of buyer power exerted by a customer, such as a retailer, on a supplier can be difficult to ascertain. The most straightforward summary measure of buyer power is buyer concentration. Buyer power is more likely to arise where one or a few buyer(s) dominate the demand side of the market. However, buyer concentration does not automatically imply buyer power. For example, supplier concentration, or selling power, may offset any concentration on the demand side of the market.

3.19 Buyer power can also be measured by examining performance measures such as profitability or the price-cost margin. For example, a retailer with strong buyer power will be able to negotiate better trading terms (e.g., higher discounts) with a supplier than a retailer with minimal buyer power. In this regard, the price-cost margin of buyers can be informative. However, price-cost margins should be interpreted with caution since they reflect a number of factors and are not indicators of buyer power alone. For example, retailers' costs structures may differ greatly with consequent implications for any comparison of price-costs margins.

3.20 In assessing the extent to which grocery retailers in the UK have buyer power, the UK Competition Commission examined the following evidence[12]:

- The size of retailers relative to suppliers;
- The prices and margins that suppliers are able to negotiate with retailers; and
- A review of e-mail correspondence between retailers and their suppliers.

<u>The size of retailers relative to suppliers</u>

3.21 The size of a retailer, in terms of its size relative to the retail market and relative to the supplier, is a key determinant of whether it has buyer power. For products where there are numerous suppliers and every retailer pays the same price, a retailer's buyer power is influenced by the size of its sales relative to total product sales, and the degree of concentration of retailers in relation to the total sales of the product.

3.22 Where there are few suppliers and prices are negotiated bilaterally between each retailer and each supplier, buyer power will be determined by the extent of a retailer's reliance on its supplier and vice versa. The extent of this reliance will be influenced by the size of the retailer relative to its supplier, the alternatives that the retailer has for supply, and the alternatives the supplier has for access to final consumers.

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[12] For details, see paragraphs 9.6-9.21 of Competition Commission (2008) *The supply of groceries in the UK market investigation*, Volume 1 Summary and Report, London. This may be accessed at: http://www.competition-commission.org.uk/rep_pub/reports/2008/fulltext/538.pdf.

3.23 In the European Commission's practice, the assessment of relative economic dependencies between buyers and suppliers has become a decisive element in the assessment of buyers' market dominance. In two cases concerning the food retail sector, the Commission focused on the fact that, on average, a share of turnover accounted for by a buyer was indispensable to the supplier if it amounted to more than 22% of the turnover of the supplier.[13]

<u>The prices and margins that suppliers are able to negotiate with retailers</u>

3.24 The prices and margins that suppliers earn in supplying retailers can provide an indication of buyer power. All things being equal, the greater the retailer's buyer power, the lower the margins earned by suppliers. However, sourcing such data can be difficult. Furthermore, the results of any analysis using such data should be interpreted cautiously since the price charged by suppliers is influenced by many different factors.

3.25 In addition to pricing data, questionnaires can be sent to suppliers seeking their views on the level of prices and margins earned from retailers.

<u>Written Correspondence between retailers and their suppliers</u>

3.26 A review of written correspondence between a retailer and its suppliers over a period of time can give an insight into the former's negotiating tactics and its relative bargaining strength vis-à-vis the seller. This can give an indication as to whether the degree of buyer power being exerted by the retailer has changed over the period under review. Furthermore, it can be useful in illustrating the precise manner in which countervailing buyer power is exercised by retailers, an issue discussed below.

Comment

3.27 How buyer power impacts on suppliers, end consumers and the market overall depends on the relative bargaining strengths and strategies of the buyers and sellers. Therefore the next section discusses how sellers and buyers with market power interact in the chains of supply.

The Interaction of Seller and Buyer Power in Chains of Supply

Relative Bargaining Strengths

3.28 The interaction of seller and buyer power in a chain of distribution is complex. A useful way of characterising the interaction is in terms of relative bargaining strengths. For example, even if a product is only available from a small number of large suppliers, they may still not be in a position to exercise their seller power (e.g., raise price) if buyers possess sufficient buyer power. Thus, buyer power can be seen as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to credibly switch to alternative suppliers.

3.29 If a buyer resells the products it purchases, i.e., is a retailer, an additional consideration is required. The ability of a large retailer to

[13] For details, see footnote 11 of BundesKartellamt (2008) *Buyer Power in Competition Law – Status and Perspectives*.

exercise buyer power is limited by the willingness of the retailer's customers, the end consumers, to buy the products of alternative suppliers. Thus, even if a large retailer is able to buy from alternative suppliers or engage in self-supply in response to an exercise of market power by its supplier, this may not be credible if the products of alternative suppliers are not considered by the retailer's customers as a suitable replacement.

The Impact of Buyer Power on Suppliers

3.30 Buyer power when possessed by a reseller, i.e., a retailer, can take a number of different forms. These include: (i) threatening to de-list a supplier's product(s); (ii) de-ranging individual package sizes or formats for a particular product(s) of a supplier[14]; (iii) refusing to list a supplier's new products; (iv) refusing to accept a proposed price rise from a supplier; (v) refusing to support a supplier's promotions; and, (vi) moving a supplier's product(s) to a "slow" part of the aisle/store.

3.31 The above bargaining strategies vary in terms of their severity for a supplier. The most extreme type of buyer power is de-listing a supplier's product(s) indefinitely. The degree of buyer power possessed by a retailer will determine which of the above strategies can credibly be implemented and for how long. Retailers who possess a high degree of buyer power will have a large number of credible strategies available to them in their negotiations with suppliers. For a retailer, however, the preferences of end consumers will largely determine its ability to exercise buyer power against a supplier. In product categories where end consumers display a high degree of loyalty to a leading brand(s), the extent to which even the largest retailers can exercise buyer power over a supplier(s) may be limited.[15] Thus, brand loyalty is an important factor when considering the role of buyer power in retail markets.[16]

3.32 The purpose of exercising buyer power by a retailer is to obtain a low price from a supplier to improve or maintain profitability. This can be achieved directly through a reduced wholesale price or indirectly by demanding so-called "below the line" (e.g., slotting allowances for space in the store) and "above the line" (e.g., marketing or promotional activities) payments from a supplier.

3.33 It should be noted, however, that a retailer may de-list and/or de-range a supplier's product(s) for reasons other than the exercise of

[14] "De-ranging" refers to the practice by retailers of limiting stocks of a product to certain stores.

[15] A recent decision by the Competition Authority (Determination No. M/08/009, *Kerry/Breeo*, 28th August 2008) to block a proposed merger involving the leading brands in the markets for rashers, non-poultry cooked meats, and processed cheese was annulled in the High Court on 19th March 2009. One of the key conclusions reached by the Competition Authority in its decision was that retailers will be unable to credibly threaten to discipline the merged entity post-merger since (a) there are no credible alternative branded suppliers, (b) entry of branded suppliers will not be sufficient within a two-year period, and (c) private label products are not considered a sufficiently close competitor in any of the three markets and, thus, cannot be used to replace the merged entity's offering. In his judgment, the judge concluded that the Competition Authority had erred in finding that there will be a substantial lessening of competition resulting from the merger in the markets for rashers and non-poultry cooked meats because it failed to correctly assess the post-merger existence of sufficient countervailing buyer power on the part of retailers such as will deter a permanent price increase by the merged entity. The Competition Authority initiated an appeal to the Supreme Court on 7th April 2009 against the ruling of the High Court of 19 March 2009 which annulled the Competition Authority's decision.

[16] In analysing the buyer power of the big supermarket chains in Austria, the Austrian Federal Competition Authority concluded that "…if brand awareness is not distinctive and private label products directly compete with branded ones, buyer power of retailers is strengthened". For details, see Federal Competition Authority (2007) *Groceries Sector Inquiry on Buyer Power of Supermarkets*. This may be accessed at: www.bwb.gv.at/BWB/English/groceries_sector_inquiry

buyer power. In the normal course of business, retailers will regularly de-list and/or de-range slow moving products in favour of more profitable products. Product turnover in a retail outlet is part of everyday business regardless of the size of the retailer.

Impact on the End-consumer

3.34 Buyer power can have positive or negative effects for consumers depending on the structure of the related (supplier and re-seller) markets. Buyer power may act as a countervailing force to any market power possessed by suppliers. It can promote greater price and non-price competition amongst suppliers.[17]

3.35 Consumers benefit if buyers, e.g., retailers, use their bargaining power to extract the lowest possible price from their suppliers and pass a proportion of the saving on to end consumers. The extent of the price pass-through to end consumers will depend upon the intensity of competition between retailers in their own market. If competition is weak in the retail market, retailers with buyer power are more likely to maintain the higher price charged to end consumers, thereby earning higher margins.[18]

3.36 Buyer power, however, can harm competition in certain limited circumstances. This can occur where one buyer or a number of buyers possess such strength that a supplier becomes dependent on the buyer(s) for its continued participation in the market, or where it becomes a necessary requirement for entry to the market. This can harm the long-term viability of suppliers.

3.37 Disparity in bargaining power amongst buyers can also harm end consumers in the medium to long-term.[19] In a market with few buyers, if one is more powerful than the rest, it will be in a stronger position to negotiate better trading terms from its suppliers. Although this may benefit end consumers in the short-term (assuming there is some price pass-through by the buyer), competition in the downstream (retail) market may be adversely affected in the medium-term if a buyer(s) possesses such strength that it can use its bargaining power vis-à-vis its suppliers to foreclose smaller, less-powerful rivals (retailers). Furthermore, this may reduce the incentive to enter the downstream (retail) market. This can harm end consumers by reducing the intensity of competition in the downstream (retail) market leading to higher prices in the medium to long-term.[20]

Concluding Comment

3.38 The focus of the current public debate surrounding the price of consumer retail products has been on the price differential that has

[17] An example of non-price competition would be greater innovation in the supply chain through new product development.

[18] Chen (2003) finds that where there is an increase in the amount of countervailing buyer power possessed by a dominant retailer in the downstream retail market, the presence of fringe competition is crucial for end consumers to benefit from this increased buyer power by way of lower retail prices. For details, see Chen, Z., 2003, 'Dominant Retailers and the Countervailing-Power Hypothesis", *The RAND Journal of Economics*, Volume. 34, Number. 4, pp. 612-625.

[19] This is sometimes referred to as a "waterbed effect". For details, see Dobson, P. and Inderst, R., 2008, 'The Waterbed Effect: Where Buying and Selling Power Come Together', *Wisconsin Law Review*, Volume 2008, Number 2, pp. 331-357.

[20] Another type of waterbed effect is where differential buyer power in the downstream market affects competition between suppliers, potentially leading to upstream consolidation and a less competitive upstream market. This, in turn, may lead to a decline in product variety and innovation in the supply chain.

emerged between NI and the ROI. Specifically, consumers in the ROI have been flocking north of the border to take advantage of cheaper prices there. Retailers in the ROI have responded to this, and to the general downturn in consumer demand, in varying degrees by seeking to reduce prices through a number of mechanisms.

3.39 Price reductions are achieved through a combination of cost reductions which may be passed on to consumers and by reducing margins. Broadly speaking, cost reductions are achieved by seeking efficiencies, i.e., reducing operating costs such as distribution costs or labour costs, and by reducing the price paid to suppliers for products that they resell. Meetings that the Competition Authority has held with suppliers and retailers across a range of consumer product categories have confirmed that retailers have over the last year been aggressively seeking reductions in the cost of product from suppliers, both directly and indirectly. In particular, retailers have been seeking greater promotional support from suppliers as well as outright reductions in the cost of products.

3.40 In terms of the public debate surrounding the issue, this development has prompted two distinct reactions; one from suppliers and another from retailers. Some suppliers have made claims that retailers are abusing their buyer power while some retailers have claimed that suppliers are abusing their seller power.

3.41 It is certainly true that, within a variety of supply chains, certain sellers have substantial power and certain retailers have strong buyer power. However, identifying the situations where seller or buyer power is problematic is not a simple task of counting the number of players in a market and calculating their market shares. The dynamics of the market and the nature of the interactions between sellers and buyers, as outlined in this chapter, need to be analysed carefully on a case-by-case basis to determine where consumers face positive or negative effects from the power plays in the market.

3.42 This note of caution is particularly important in the current economic environment. There have been two shocks to consumer retail sectors in the ROI. First, our nearest and most significant trading partner, with whom we share a land border, has experienced a substantial currency depreciation against our own currency. Second, there is a significant global economic downturn that appears to have affected the Irish economy disproportionately. The implication of these shocks for the consumer retail sector, and their associated supply chains, is that a new equilibrium must be reached. Much of the current public debate reflects the tensions that have emerged between suppliers and retailers during this transition period.

3.43 If the consumer price differential that has emerged between the ROI and NI is to narrow, retailers must, without exception, seek cost reductions by pressurising suppliers to give them better deals. Some retailers will be more effective at this than others. Moreover, suppliers who either cannot or will not provide better deals will be by-passed in favour of suppliers who will. It is therefore of the utmost importance that the abusive exercise of buyer power is not confused with <u>legitimate</u> actions by retailers who seek cost reductions from suppliers in order to respond to the emerging economic reality. The next Chapter attempts to provide an overview of <u>illegitimate</u> behaviour by suppliers and retailers as set out in both European and Irish law.

4. IMPORT AND DISTRIBUTION: GROCERIES

Introduction

4.1 This chapter considers the grocery supply chain, where "groceries" comprise four categories of goods: (i) food, (ii) non-alcoholic beverages, (iii) non-durable household goods and (iv) personal care goods.

Products

4.2 Groceries have a weight in the CPI of 13.93%, indicating that these goods make up a large proportion of the average consumer spend.

- Food includes breads and cereals, meat, fish, milk, cheese and eggs, oils and fats, fruit, vegetables, sugar, jam, honey and chocolate and confectionery.
- Non-alcoholic beverages include tea, coffee, soft drinks, juices and mineral water.
- Non-durable household goods include cleaning products, washing powder, air fresheners and cling-film.
- Personal care products include shower gel, toothpaste, razors, shampoo, baby powder and disposable nappies.

4.3 These product categories are typically included in an individual's weekly shopping. For the purposes of the remainder of this chapter, groceries are categorised as:

- Fresh food: Meat, fruit and vegetables, eggs and fresh dairy products, e.g., milk;
- Branded products: Goods that are branded by the supplier, e.g., Kellogg's cereal, Heinz beans, Cadbury chocolate, Pantene shampoo, Fairy Liquid; and,
- Own-brand or exclusive products: Goods that are branded/labelled for a retailer and only sold by that retailer, e.g., Tesco value, St. Bernard (Dunnes Stores), ALDI and Lidl products.

Retail Level and Wholesale Level

Types of Operators

4.4 Groceries are sold in a variety of retail outlets such as supermarkets, discounters and convenience stores. A number of specialised retail outlets, such as bakeries and butcher's shops, are also active in this sector. Personal care products tend to be bought in specialised stores such as pharmacies, e.g., the Boots chain. A variety of business models can be distinguished.

4.5 The grocery retail and wholesale chain in ROI is quite complex.[21] Traditionally, both levels were clearly identifiable and distinct: the retail level consisted of grocery stores that sold goods directly to

[21] As part of the *Grocery Monitor* Project, the Competition Authority gathered historical information for the period 2001 to 2006 about the retail and wholesale grocery chain in the ROI. Since publication of the Report, with the exception of the BWG acquisition of Mangans in May 2008, there has been no new entry or exit to the market, and so the relative market positions of each of the major retailing and wholesaling groups in general are unchanged.

consumers, and the wholesale level consisted of grocery wholesalers that purchased groceries directly from producers, manufacturers or importers for resale to retailers. The modern system, however, is quite different. Some operators are active across more than one level in the chain. Thus, for example, some retailers combine the retail and wholesale levels. Some retailers even operate in the supply level by selling own-branded products.

4.6 There are three principal types of operators at the retail level: vertically-integrated retailers, affiliated retailers and independent retailers.

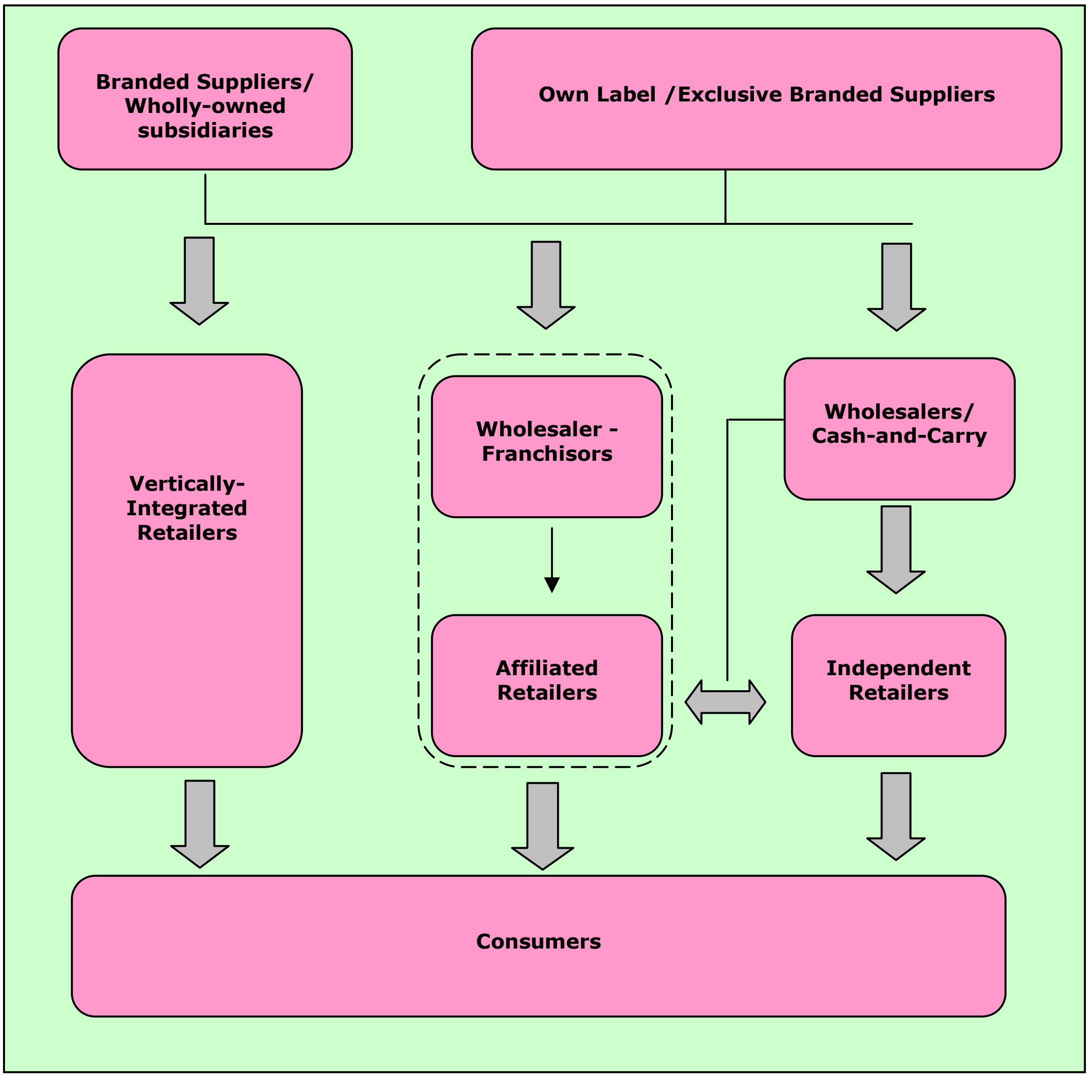
- Vertically-integrated retailers own and operate multiple retail outlets across the ROI (and in effect, carry on their own wholesaling). These retailers sell both branded and own-branded products, and can generally entirely satisfy a typical consumer's weekly grocery shopping. The six vertically-integrated retailers operating in the ROI are ALDI, Dunnes Stores, Marks & Spencer, Lidl, Superquinn and Tesco.
- Affiliated retailers typically own and operate one retail outlet (and in limited cases, several outlets) under a retail brand or fascia which is under licence from a wholesaler-franchisor and is used by other retail outlets. Five 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 Quickpick. BWG Food has five brands: XL Stop & Shop, Vivo and Xpress Stop and Mace (a group of interrelated brands under the name SPAR, EUROSPAR and SPAR Express), Musgrave has four brands, Centra, Daybreak, DayToday and SuperValu.
- The third retail model in the grocery sector is the independent retailer model. Like affiliated retailers, independent retailers typically own their own stores. Unlike the affiliated retailers, however, they do not operate under a common retail brand that is licensed by a wholesaler-franchisor. They are generally smaller than vertically-integrated retailers and often specialise in a more narrow range of products. Independent retailers are not vertically-integrated with the supply level in any sense, and their dealings with wholesalers are limited to the purchase of goods for resale.

4.7 Two types of operators at the wholesale level can also be distinguished: wholesaler-franchisors and independent wholesalers.

- Wholesaler-franchisors engage in the traditional function of buying goods from suppliers for resale to retailers; they also license one or more retail brands or fascias to retailers. The five wholesaler franchisors operating in the ROI are ADM Londis, Barry Group, BWG Foods, Gala Wholesalers and Musgrave. The wholesaler-franchisors are therefore the counterparts of the affiliated retailers previously discussed.
- Independent wholesalers engage in the traditional function of buying goods from suppliers for resale to retailers; they do not license a brand or fascia to retailers. They are generally known as cash-and-carry wholesalers. They operate on a smaller scale than the wholesaler franchisors but compete for business with them to supply independent retailers.

4.8 Figure 7 provides a stylised picture of the grocery supply chain in the ROI. The figure illustrates in detail only the wholesale and retail levels in detail. The supply level is discussed in more detail later in this chapter.

Figure 7: Grocery Retail Supply Chain



Market Presence of Operators

4.9 There were over 6,400 grocery retail outlets in the State as of 31st December 2006, of which 55% outlets were operated by independent retailers, 40% by affiliated retailers and about five per cent by vertically-integrated retailers.[22] Despite the large number of stores owned by independent retailers and affiliated retailers, the retail level of the grocery supply chain was relatively concentrated. Among the vertically-integrated retailers, Tesco and Dunnes Stores had the greatest shares of turnover in 2006, between them accounting for almost 30-35% of total grocery turnover in the ROI. Across all retail brands, that is, retail brands operated by both vertically-integrated and affiliated retailers, during 2006 Tesco, SuperValu and Dunnes Stores together had the greatest share of turnover, accounting for approximately 45-50% of grocery goods turnover in the ROI. Over the period from 2001 to 2006, the relative position of the major retailers remained unchanged. However, due to the entry of ALDI and Lidl, the

[22] "*A Description of the Structure and Operation of Grocery Retailing and Wholesaling in Ireland: 2001-2006*". Grocery Monitor Report No.1, The Competition Authority, March 2008.

share of turnover of the other vertically-integrated retailers and the SuperValu retailers has declined marginally.

4.10 The wholesale grocery sector is also concentrated, in the sense that a few operators account for a large share of turnover. Moreover, shares of turnover remained remarkably stable over the period since 2001, despite expansion by all players. It is estimated that over 95% of the wholesale turnover in the ROI grocery sector is attributable to five wholesalers, with just two of them accounting for around 80% of the total.[23]

The Distribution System

4.11 Retailers and wholesalers have different distribution capacities that affect their efficiency. Operating multiple stores allows the vertically-integrated retailers to have a centralised distribution network. Centralised distribution involves the delivery of a variety of grocery goods to retail outlets in a single visit. Suppliers deliver in bulk to the vertically-integrated retailer's distribution centre, and the retailer then delivers to its stores. This centralised model of distribution is more cost-effective than the traditional distribution model whereby a retail outlet is restocked through many deliveries from various suppliers and wholesalers. Vertically-integrated retailers utilising this distribution system also benefit from the economies of scale and scope that can be achieved through volume-based discounts from suppliers and producers, on the basis that the product does not need to be handled as much by the supplier, and instead is handled by the retailer. Each of the vertically-integrated retailers, with the exception of Dunnes Stores, uses centralised distribution of this type.

4.12 Like the vertically-integrated retailers, some of the wholesaler-franchisors have the capability to centrally distribute; however, the size of the networks they control varies more widely. At one end of the spectrum, approximately 79% of Musgrave's wholesale grocery turnover is delivered through its central distribution system, 19% is delivered directly by suppliers, and just two per cent comes from cash-and-carry business. At the other end of the spectrum lies ADM Londis, who for 2006 reported that just 15% of their wholesale grocery goods turnover came from goods that are delivered though central distribution, with the remainder being delivered directly by suppliers.

4.13 Given that the vertically-integrated retailers and wholesalers distribution centres vary in size, not all groceries bought by retailers and wholesalers from suppliers are stored in these distribution centres. Apart from capacity constraints, there are also storage capability constraints. For example, some distribution centres do not have the storage capability for chilled or perishable goods, and so these are delivered directly by suppliers to retail outlets. Other products particularly lend themselves to direct-to-store delivery by the supplier, e.g., bread, catering food. Routing these types of goods via a distribution centre may not be practical.

4.14 Distribution of goods from the wholesaler-franchisors to their affiliated retailers is achieved through central distribution and "central billing". Typically, wholesaler-franchisors negotiate terms and conditions with their suppliers for the supply of goods for resale to retailers. Wholesaler-franchisors that utilise centralised distribution facilities then take physical possession of the goods purchased from the supplier,

[23] *Ibid* pg 54

storing the goods in their warehouses and delivering them to affiliated retailers who have purchase the goods.

4.15 In other cases, the wholesaler-franchisor never takes physical possession of the goods from suppliers. Instead, the suppliers deliver directly to retailers. However, as with centrally distributed goods, the orders are placed by retailers with the wholesaler-franchisor, and not with the supplier. These are centrally billed goods. The balance between centrally distributed goods and centrally billed goods depends, *inter alia*, on the distribution and warehouse capability of the relevant wholesaler-franchisor.

4.16 The strength of a retailer/wholesaler's centralised distribution system has a significant effect on its ability to respond to the depreciation of STG by importing directly from the UK. Later sections shall consider this issue in more detail.

Regulations

4.17 Report No.3 of the Competition Authority's *Grocery Monitor* project examined the retail planning system as applied to the grocery sector from 2001 to 2007. The Competition Authority found that, despite the growth in the number and size of grocery retail outlets in the ROI since 2001, the planning system acts as a barrier to competition in grocery retailing in three ways:

i. Restrictions on the size of a grocery retail outlet;

ii. Restriction on where a grocery retail outlet can locate; and,

iii. Uncertainty regarding the grant of planning permission, which can raise the cost and delay the arrival of a new retail outlet.

4.18 These factors limit competition between grocery retailers and also limit competition between different grocery brands. They combine to limit consumer choice and value for money. There has been an increase in the overall number of grocery outlets operating in the ROI and an increase in floor-space devoted to the retailing of grocery goods. However, the size, location and rate of expansion of grocery retail outlets has been restricted in the following manner:

- The ROI does not have any large-scale low cost grocery retailers, as exist in other European countries including NI;
- Discount retailers face more stringent limitations on outlet size than other grocery retailers;
- The size restrictions on grocery retailers means there is less shelf space in retail outlets and so competition between the branded groceries that sit side-by-side on supermarket shelves is reduced; and,
- Consumers throughout the ROI have been denied the benefits of competing grocery retailers in their local area due to prolonged planning delays.

Nature of Competition

4.19 Grocery retailers compete on three levels, namely, on pricing, product range and location of retail outlets. This section will look at each of these levels in turn.

Pricing Behaviour

4.20 Vertically-integrated retailers set pricing in their stores in a centralised way – i.e., items are typically priced uniformly across the country. Store managers are allowed limited discretion to deviate from the national prices on short-life groceries or when goods are approaching their best before date. Generally the wholesaler-franchisors have an influence on pricing of their affiliated retailers, through some form of price recommendation. However, affiliated retailers are free to deviate from such recommendations.

4.21 Promotions are also set in a centralised way and are uniform across vertically-integrated retailers. There are some exceptions to this. Depending on the presence of competitors, where a store is underperforming or if it has recently opened, promotions may increase in a particular store location to respond to local circumstances. There is a good deal of variation in terms of centralised retailer promotions, with retailers running between 12 and 52 promotional cycles annually. The wholesaler-franchisors also set promotions in a centralised way, but some are not applied uniformly across the affiliated retailers. These promotions may vary by store size, location, consumer preferences and local competition.

4.22 As well as centralised promotions, promotions are also driven by the offers retailers and wholesalers get from their suppliers. The retailers' and wholesalers' bargaining power will play a significant role here. The higher the percentage of a supplier's business accounted for by a particular retailer or wholesaler, the more buyer power the retailer or wholesaler will have. For example, if a retailer accounts for 50% of an individual supplier's sales in the ROI, the retailer will be able to exert pressure in order to negotiate deeper promotions, as the supplier has more to lose if their product does not achieve shelf-space. On the other hand, the supplier's business may represent a very small proportion of total business for the larger retailers and wholesalers.

4.23 The larger operators use their power to demand greater trade discounts and promotional offers from their suppliers and to obtain more favourable terms than those available to their competitors. They attempt to achieve promotions that will differentiate their businesses, but also want to ensure that they can match what other operators are offering. The effectiveness of the retailers' and wholesalers' buying power also depends on whether they face significant seller power from the suppliers. Later sections will look in greater detail at this. It should be noted that while promotions and discounts represent a significant part of any retailer or wholesaler's business strategy, these are not picked up in any consumer price survey. Therefore, the net price to consumers in the ROI having accounted for the "two for one" or "50% off" offers is not actually captured in cross-border price surveys, most notably in the NCA price surveys of September 2008 and February 2009 or the price surveys undertaken by Eurostat.

Location

4.24 The location of a retail outlet is an important strategic choice for a retailer, given that the majority of consumers appear to select their grocery retail outlet principally on the basis of convenience or proximity of location.[24] The choice of location involves consideration of

[24] AC Nielsen Shopper Trends Survey 2007

population densities and the demographic characteristics of the population residing in the outlet's catchment area, as well as the presence of retail outlets operated by competitors.

4.25 Retailers, particularly convenience stores, also compete on opening hours. The concept of a "convenience store" implies not only a convenient location but also longer opening hours. Opening hours for affiliated retailers range from 13 to 15 hours on average, higher than the 10 to 13 hours on average of the vertically-integrated retailers (excluding Tesco).

Product Range

4.26 Grocery retailers also compete with each other on the basis of product range. Traditionally, ROI consumers have had very strong brand loyalty, so it was important for retailers to ensure that they offered all of the top brands, including favourite Irish brands as well as preferred international brands. Penetration of own-label products has been relatively low compared with other EU countries. However, in the current economic climate and as ROI consumers are becoming more price-sensitive, own–label products and discount retailers are achieving much higher levels of penetration. The NCA price survey conducted in September 2008 found that grocery price competition had become more concentrated on own-brand goods. When they compared grocery prices at ALDI, Lidl, Tesco and Dunnes Stores, the NCA found a price differential of 59.3% between the cheapest and most costly outlets on a basket of 19 items in December 2007, but this had dropped to 33.9% in August 2008 on a basket of 34 items.

Comparison with NI

4.27 The grocery retail landscape in NI has a number of differences to that found in the ROI. Of the five largest grocery retailers and wholesalers in the NI, two of the top five do not operate in the ROI. These are Sainsbury's, with a market share of nine per cent, and Asda, with a market share of 12%. Tesco is the largest grocery retailer in NI, with a market share of 23%.[25] All three retailers began operating in NI relatively recently. Tesco and Sainsbury's opened their first stores in NI in 1996, and Asda opened its first store in 2005. This followed a takeover of 12 formerly Safeways stores from Morrisons.[26] The remaining large operators in NI are Musgraves, with a market share of 11%, and Dunnes Stores, with a five per cent market share.

4.28 Despite their presence in NI, as far as the Competition Authority is aware the UK multiples do not have separate NI buying offices. NI is treated as a district of the UK and so all grocery goods supplied in NI come from the UK multiples' supply chain and not from ROI. This has two main effects. Firstly, as the UK multiples have a national pricing policy, NI retail stores' goods are priced to a market of 60 million consumers, and not 1.75 million. They therefore benefit from volume sale discounts that ROI retailers and wholesalers cannot get. Secondly, because there is a national pricing policy, the costs of distributing goods to NI are absorbed with the rest of the UK, whereas in the ROI these extra costs are internalised. In effect, stores in NI are subsidised by the UK market structure.

[25] Groceries Market Investigation. Competition Commission April 2008 available at http://www.competition-commission.org.uk/inquiries/ref2006/grocery/index.htm
[26] Morrissons no longer have any stores in Northern Ireland.

4.29 Furthermore, there are no retail planning caps in NI. Therefore, provided that a retail planning proposal is compatible with the planning policies of an area, a planning application will be granted. As discussed previously, the Retail Planning Guidelines have ensured that the ROI does not have any large-scale low cost grocery retailers, as exist in NI. Discount retailers, such as Asda, function on a large-turnover, low-margin business model and therefore require substantial floor-space to operate. The retail planning caps on discount food stores in the ROI are preventing these types of retailers from entering the ROI market without having to alter their business model, thus potentially preventing such retailers from introducing significantly lower prices to this market.

Supply Chain

Types of Operators

4.30 At the supply level of the grocery supply chain, there is a wide variety of operators. Retailers and wholesaler-franchisors are supplied by a variety of suppliers that produce, manufacture or import goods. Suppliers can be characterised by type: indigenous suppliers; wholly-owned subsidiaries of international companies; third party distributors; and own-brand/exclusive brand suppliers. Goods, in turn, can also be characterised by type (Fresh food, other food products, beverages and non-food) and by marketing value (branded, own-brand/label and exclusive brands). In what follows, each type of good is described in terms of supplier type:

- <u>Fresh food</u> includes meat, fruit and vegetables and dairy. This category is predominantly supplied by indigenous suppliers. ROI consumers want Irish meat and dairy. Based on information provided in the Grocery Monitor Report, top suppliers of fresh meat and fish, in terms of retailer coverage, include Kerry Group, Kepak, Carton Brothers Ltd, AIBP Cahir Ltd and Tenderlean Meats.[27] Indigenous fruit and vegetable suppliers source produce from local and international suppliers. Apart from seasonal locally grown fruit, such as berries, the majority of fruit comes from Europe and the Southern Hemisphere. Approximately half of the vegetables sold are Irish-grown, with the remainder imported. The main fruit and vegetable suppliers are Total Produce, Keelings, Country Crest, K & K Packs and Donnelly Fruit & Veg. Top suppliers of dairy, milk, cheese, eggs and bread products are Glanbia, Kerry Group, Breeo Foods, Irish Pride Bakers and Cuisine de France.
- <u>Other food products</u> include ambient products such as confectionery, sauces, canned food, baby food, condiments and cereals. This category is supplied by a mix of indigenous suppliers (e.g., Kerry Group), ROI offices of international brands (e.g., Unilever, Nestle and Cadbury) and third party distributors (e.g., Tennant & Ruttle and Allegro). Other large suppliers in this category are Master Foods, Green Isle, Bachelors, Cuisine de France and Chivers Ireland. Vertically-integrated retailers and wholesaler-franchisors may also import own-branded goods or exclusive brands.

[27] The top suppliers listed throughout this section are the top 5 suppliers, in terms of coverage of retailers, as gathered during the Grocery Monitor Project.

- Beverages tend to be branded and own-branded products which are supplied by indigenous suppliers, imported through ROI offices of international brands and third party distributor or sourced directly from foreign suppliers. Leading non-alcoholic beverage suppliers include Coca Cola, C&C, GlaxoSmithKline, Richmond Marketing and Mulrines Beverages.
- Non-food relates to non-durable household necessities such as cleaning products and personal care products such as shampoo. The majority of these products are international brands imported through the ROI offices of the relevant brands, e.g., Unilever, or through third party distributors, e.g., Johnson Brothers (which is the third-party distributor for Procter & Gamble). Larger retailers and wholesaler-franchisors may also import own-branded goods or exclusive brands directly from foreign suppliers, e.g., Boots' own-brand personal care range. The largest suppliers in this category are Georgia Pacific, Unilever, Procter & Gamble, Kimberly Clarke Ltd and Reckitt Benchiser.

4.31 Table 5 lists the top ten suppliers across all retailers and wholesaler-franchisors in the ROI in terms of retailer coverage.[28] The list combines branded and own label suppliers. There are 20 different suppliers in the combined top ten suppliers of wholesaler-franchisors, and 51 different suppliers in the combined top ten suppliers of vertically-integrated retailers. This indicates the breadth of suppliers operating in the grocery sector. One retail group stated that they have over 400 suppliers.

Table 5: Top Ten Suppliers of Grocery Goods

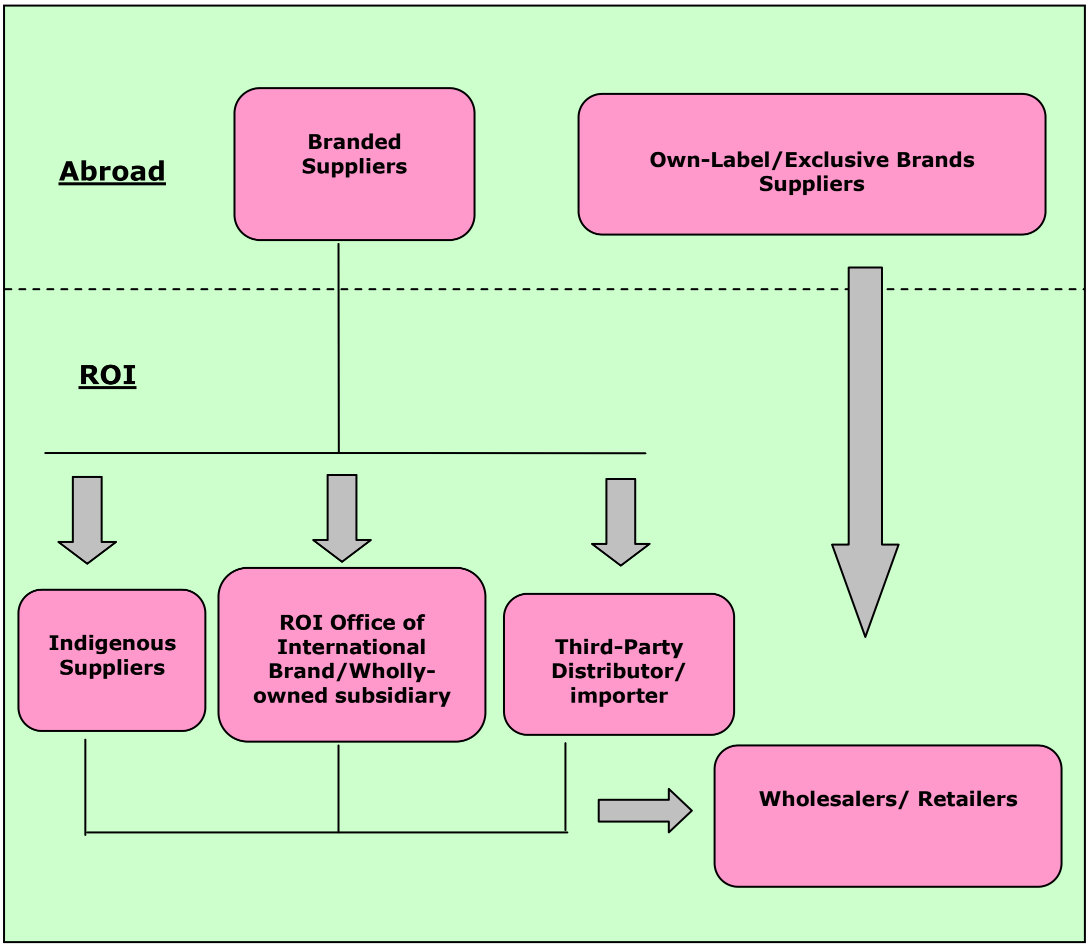
Top Suppliers of Grocery Goods
Kerry Foods
Breeo Foods
Unilever Ireland
Cadbury Ireland
Coca Cola Bottlers Ireland
Glanbia
Cantrell & Cochrane
Cuisine de France
Diageo Ireland
Procter & Gamble

Source: Grocery Monitor Report. Meetings with retailers conducted during the course of this Report indicated that their suppliers had not materially changed.

[28] This table is based on data received as part of the Grocery Monitor Project. It contains information on both groceries and alcoholic beverages.

4.32 For both wholesaler-franchisors and vertically-integrated retailers, just over half of their top ten suppliers are ROI manufacturers and producers, with the remainder being international suppliers. The majority of this indigenous supply probably comprises fresh produce. As described above, other food, beverage and non-food goods are the categories that are comprised of predominantly imported international brands; these goods have traditionally been imported through wholly-owned ROI subsidiaries or third-party distributors. Many retailers and wholesaler-franchisors also import own-label or exclusive brands from foreign manufacturers. Each of these import distribution arrangements are now described in turn.

Figure 8: Depiction of Traditional Importation Routes in Grocery Retailing



4.33

ROI Office of International Brands

4.34 Many branded manufacturers have wholly-owned subsidiaries present in ROI, for example, Coca Cola, Cadbury, Mars, Kellogg's, Unilever and Nestlé. The head office of the branded company tends to be located somewhere in Europe, for example, the UK, the Netherlands or Switzerland. Suppliers often have a portfolio of brands in product categories and across product categories. For example, among Unilever's portfolios are the Surf and Persil brands in Non-Food, and the Hellmann's and Knorr Food brands.

4.35 The majority of products offered by these suppliers are imported into the ROI through their UK office. However, only a small percentage of these products are actually manufactured in the UK. Retailers have traditionally sourced these brands through the locally established operation. Establishing ROI offices ensures that brands are marketed to the ROI consumer and that promotions are targeted accordingly. Many suppliers and retailers stated that consumers are not the same across jurisdictions and that it is important to have locally-targeted marketing that caters to consumer types and tastes. These offices have a team that is aware of ROI consumers, their tastes and preferences; they also do the local advertising for the brand.

4.36 Recently, however, as will be described in greater detail later, some retailers are by-passing the ROI offices.

4.37 In addition to marketing and promoting their respective brands, suppliers often have considerable distribution capacity. Depending on the retailer, wholly-owned subsidiaries of multinational producers or manufacturers distribute their branded product either to the centralised distribution centre of the retailers or wholesaler-franchisor, or directly to retail outlets.

Third Party Importer/Distributors

4.38 Some manufacturers do not operate a local ROI office, instead choosing to distribute their product via a third party distributor, e.g., Tennant & Ruttle, Johnson Brothers or Allegro. Third party distributors tend to have sole or exclusive distribution arrangements with a number of suppliers and manufacturers and offer retailers a portfolio of products across different product categories. Such a distribution arrangement with a third party distributor tends to be connected to the UK office of the manufacturer, although it may be located in another country. Again, while most products are imported through a UK office, only a small percentage of these products are actually manufactured in the UK. In this arrangement the manufacturer is responsible for the brand advertising.

4.39 Third party distributors can offer a range of services, from full promotional and logistical support, similar to that offered by an office in the ROI of the brand, to simply delivering the product. Depending on the retailer, third party distributors deliver the product to the retailer or wholesaler-franchisor’s distribution centre or straight to the retail outlet. Some retailers may by-pass the third party distributor and deal directly with a foreign office of the branded manufacturer; this might be because of retailer scale or because the retailer has operations in that country. In this instance, depending on the arrangement, a third party distributor may still have some role to play, e.g., by providing in-store promotional support.

Own-brand/Exclusive brand Supplier

4.40 Retailers and wholesalers also contract suppliers to manufacture own-brand products, e.g., Tesco have own-brands such as Tesco Value and Tesco Finest; Dunnes Stores have St. Bernard; and Marks & Spencer only offer own-brand goods. Own-brand suppliers manufacture and label products on behalf of the particular wholesaler or retailer. Own-brand products are sometimes supplied by the same manufacturer as the branded goods; in such a case, however, they would have the own-brand specifications of the retailer.

4.41 In addition, discounters stock exclusive brands. Discounters tend to carry a more limited product range than other grocery outlets, in that for each product line they tend not sell a range of products but only one exclusive product. Suppliers of products to discounters get exclusivity for the product line.

4.42 The difference between own-brand and exclusive brands is the degree of association between the label and the retailer. Retailers and wholesalers of own-brands do their own marketing for own-branded products, whereas exclusive brands are generally not intended to establish a high degree of association between the brand and the retailer.

Nature of Competition

4.43 Branded suppliers compete on two levels. Firstly, they compete by building brand awareness, and secondly, they compete for consumers through price and promotions offered to retailers.

4.44 Suppliers compete by building consumer brand awareness in order to stimulate consumer demand for their products. Most suppliers compete in much wider markets than the UK and the ROI, and often market their brand across jurisdictions. Sometimes suppliers name products differently across jurisdictions, and more targeted marketing will be done regionally, for example for the UK and the ROI, or for the ROI alone by the ROI office of the brand.

4.45 Secondly, suppliers price and market their products differently for different markets according to local conditions. In the ROI, suppliers compete for retailers' business, and in turn for consumer demand, through price and promotions. The net price to retailers is driven by promotions and off-invoice discounts. Traditionally in the ROI, suppliers have priced high and offered retailers promotions or rebates, which in effect reduce the retailers' cost of product or "net price". Therefore, in periods without promotions the price is high and during promotions the price is low. This is commonly known as a "High-low" pricing policy.

4.46 A high-low pricing policy is popular with retailers and suppliers alike. Promotions, like "two-for-one" or "50% extra free", both encourage increased consumption and make prices less transparent which in general dampen price competition. Offering discounts and promotions drives sales by bringing footfall into stores. Rebates from suppliers to retailers are not as transparent as promotions in terms of the benefits they can bring to consumers.

4.47 The number of promotions and/or the size of rebates that a supplier offers to its retailers will vary by brand and across retailers. The value of the brand, i.e., whether or not it is a "must-have" brand, and the size of the offer (e.g., "buy-one-get-one-free" or "50% off") will influence the choice of promotion. The response of consumers, and thus the value of the promotion, will influence a supplier's choice of offer and the retailers' demands for such offers from suppliers.

4.48 The rebates and promotions offered to a retailer are also influenced by the scale and efficiency of the particular retailer. A retailer that has strong buyer power and is more efficient, i.e., one that has a central distribution system, may negotiate volume discounts as the product does not need to be handled to the same extent as where the supplier delivers direct to retail outlets. Therefore, the efficiency of a retailer, and in turn the supplier's cost in delivering the product to the retailer, will be reflected in the cost of the product to the retailer.

4.49 Brand advertising tends to be done by the branded manufacturer. However, promotional competition can be delivered through the ROI office of the international brand or through a third party importer-distributor. Third party importer-distributors compete for their branded portfolio by offering cost efficient distribution systems and service quality.

Comparison with NI

4.50 The distribution system in the UK is more efficient than the distribution system in the ROI. The UK distribution model is built on fully developed retailer central distribution systems. NI is part of the UK market and uses the distribution structure of the UK. With a few exceptions, grocery retailers in NI do not use the ROI offices of international brands or third party distributors in the ROI. Thus, retailers in NI benefit from the efficiency of the UK distribution system and this is reflected in their cost of product. Additionally the cost of delivering product across the Irish Sea to NI is absorbed into the UK overall costs.

4.51 The prevalent pricing policy in the UK is different to that typically followed in the ROI. In the UK, there is less promotional activity and prices to retailers are close to the net price; this is known as Every Day Low Pricing or "EDLP". A small number of suppliers also have an EDLP policy for the ROI, and recently, as will be discussed later, some retailers in the ROI have been pushing for a move towards EDLP for a number of reasons. NI has the same pricing as the UK.

Supplier Price Differentials

4.52 Suppliers of products imported into the ROI, whether by the ROI offices of international brands or third party distributors, price their products based on cost of product and the cost of doing business, plus the margin. Similarly to retailers, the margin is assessed by reference to what the ROI consumer is willing to bear.

4.53 Often the ROI offices of branded companies and third party distributors buy product from the UK office in EURO at an (internal) exchange rate fixed by the branded company. International branded companies operate in many jurisdictions and currency zones, and so they hedge the exchange rate to minimise risk. Generally, for suppliers, the cost of product is the portion of their price to retailers that may be affected by exchange rates. The cost of product as a percentage of total cost to suppliers varies from product to product. The rest of the cost price relates to the cost of doing business in the ROI.

4.54 There are some cost differences between the UK and the ROI which would be expected to feed into final prices. As set out in Chapter 2, the cost of doing business is higher in the ROI, e.g., the cost of utilities, rent, insurance, transport and distribution costs and advertising. All operational costs are local costs and are not affected by exchange rates. Suppliers are affected by these differences almost to the same extent as retailers.

4.55 Economies of scale affect how operational costs translate into final prices. For example, while NI also has transport/shipping costs across the Irish Sea, retail multiples in NI are part of larger UK operations. Transport costs to NI are absorbed into the overall UK costs through national pricing by the UK multiples. NI is part of the UK, which has a market of 60 million people; the ROI is a market of four million people.

Consequently, the cost of transporting products to NI is spread over a market of 60 million, whereas the cost of transporting product to ROI is spread over a vastly smaller population. All other things being equal, due to these economies of scale the final cost of suppliers' product in the ROI is likely to be higher than in NI.

4.56 In addition, the efficiency of the UK central distribution model in comparison to the ROI retail distribution system will affect the final price to consumers. The population in the ROI is more thinly spread than the UK. Compounded with a less efficient distribution model, this means that product delivery to retailers in the ROI is more costly. The demographics of ROI, in terms of low population density, and smaller supermarkets, means that, overall, products have higher transport costs - that is, products are broken down into smaller quantities for delivery in the ROI than to UK supermarkets. This extra step in the distribution process adds a cost. Regardless of whether these costs are incurred by the supplier or the retailer, they will be incorporated into the final cost of the product. The ratio of these costs to the cost of product will vary by product, depending on the volume and size of product.

4.57 The final remaining aspect of the price differential is margin. The element of the differential not attributable to the extra cost of getting the product into retail stores could be described as an "Irish premium". In some cases it is negative, with suppliers making a smaller margin in the ROI than the UK, whereas in other instances cases it is positive, to different degrees.

4.58 International branded companies set their prices to retailers in different jurisdictions along a "price corridor". A price corridor is a pricing strategy whereby the manufacturer has a fixed base price that serves as a reference, which is usually the price in the manufacturer's home country. A margin is then set for the prices to be changed in the various countries in which the manufacturer sells its product; this margin will be altered in line with demand and supply in that country. The price corridor seeks to ensure that, within the given price range, no arbitrage trade should be able to occur. That is, a market will not develop in buying and reselling their product across countries.

4.59 Suppliers contend that the price difference between the UK and the ROI in the price corridor is due to the differences in the cost of doing business; this differential in the cost of doing business between the UK and the ROI translates into a single digit percentage difference in the price of product. International suppliers monitor the price corridor to ensure that prices across jurisdictions are not too different; otherwise customers would source from another office or distributor, or consumers would buy less of the product or source it themselves from elsewhere. Suppliers contend that recent differences in price between NI and the ROI, to the extent that they are above the natural differences arising from the cost of doing business in each jurisdiction, relate solely to exchange rate differences that have not yet settled at a new equilibrium.

4.60 All of the above factors affect the price at which a supplier of imported goods sells to a retailer, who in turn is also faced with the higher costs of doing business in the ROI. Most of these factors also impact on the price of ROI produced goods sold in both the ROI and the UK, except that the costs of transporting goods across the Irish Sea would be reversed.

4.61 Economies of scale of retailers also affect the price a retailer pays for products. Grocery multiples in the UK are much larger in size and volume of sales than ROI grocery retailers, and therefore are able to negotiate a better deal with suppliers. The margin that the retailer earns above its cost base will ultimately depend on what the consumer is willing to pay. Due to financial difficulties both globally and domestically, the ROI consumer's sensitivity to price has changed significantly in the last six months to a year; this behavioural change has put pressure on margins all the way up the supply chain. The following section describes how suppliers and retailers are reacting to this new dynamic.

Impact of STG Depreciation & Reaction of Retailers and Suppliers

4.62 For the majority of retailers, wholesalers and suppliers, the depreciation of STG has had a significant impact. The extent of the price differential as highlighted in the NCAf reports, coupled with the effects of the recession, has led to increasing amounts of pressure being placed on grocery retailers and suppliers operating in the ROI to reduce the end prices to consumers. The extent of this pressure, reflected in reduced footfall in supermarkets and decreased spending, has led some retailers and suppliers to completely alter their business strategy in the ROI.

4.63 For other operators, the reaction has been less extreme. The discounters, for example, have not been hit as severely by the slowdown in economic activity as other retailers, because consumers perceive them as a cheaper alternative to their regular shopping routine. This has resulted in many discounter outlets actually experiencing increased consumer spending in recent months as more consumers shop around for the cheapest offerings. At the same time, very little of the discounters' product ranges are purchased in STG, so these companies have not had to alter their business strategies in response to the STG depreciation.

4.64 The following section examines some of the steps that the retailers, wholesalers and suppliers have taken in order to pass on the exchange rate gains. In general, firms have reduced prices, increased their promotions and given larger discounts. It is difficult to separate which course of action was taken specifically in reaction to the slowdown in spending. All retailers and wholesalers have reported that they are working to reduce their cost base, and working with suppliers to reduce supply chain costs. This is in response to the challenging economic environment, as well as an attempt to pass on to consumers the benefits of the strong EURO. While retailers, wholesalers and suppliers are reacting to both effects, in general the following section focuses on their reaction to the STG depreciation.

Retailer and Wholesaler Reaction

4.65 In recent months, the majority of retailers and wholesalers have attempted to renegotiate prices with their suppliers, in an effort to bring prices to consumers closer to that in NI. The larger multiples and wholesalers have had greater success in obtaining a positive response from suppliers than smaller operations. This has much to do with buyer power and the importance of their custom to suppliers. Without price reductions or an increase in promotions, many of these retailers and wholesalers have threatened to find an alternative source of supply. The likelihood that this threat will materialise has also impacted on whether these negotiations are successful, because in many cases there are constraints on retailers finding an alternative source of supply.

4.66 Some retailers and wholesalers have threatened to substitute the supplier's product with another brand. However, substituting the product may not be an acceptable option for a retailer where the product is a "must-have" brand that the consumer expects to find as part of any complete product range.

4.67 Alternatively, retailers and wholesalers have threatened to by-pass ROI offices of suppliers and third party distributors by going straight to the head office or the UK office of the brand. Tesco appears to have taken this path and in doing so has radically altered its business strategy. It has announced publicly that it is actively changing its source of supply on many products and is now buying directly from the UK.[29] It continues to buy from Irish suppliers where it has been able to negotiate better terms of purchase, but where ROI suppliers have not lowered their prices or increased the quantity of promotions offered, Tesco is now sourcing from the UK office of many brands and using its own UK supply chain. Other retailers and wholesaler franchisors are also taking this approach but on a more modest level, given that they do not have as efficient a supply chain established in the UK as Tesco. Retailers and wholesalers that have taken this route to supply, even taking into account the additional transport costs, find that the cost of product is still cheaper than had the same products been sourced in the ROI.

4.68 While some retailers and wholesalers have been successful in buying from the UK, some of the smaller retailers and wholesaler-franchisors stated to the Competition Authority that, on attempting to switch to direct supply from the head office, they were instructed to go back to the ROI office or distributor and re-negotiate with the ROI supplier. ROI is a small market of four million, in comparison to the UK which has a market of 60 million. Therefore, retailers that do not have a large presence beyond the ROI or that do not have sufficient scale in volume sales may not have sufficient power to negotiate with head offices of international brands. Nevertheless, some firms have been able to get around this. For example, one wholesaler-franchisor is using a sister wholesaler in the UK to buy on its behalf; it then imports the goods into ROI.

4.69 Irrespective of whether a supplier will facilitate relocating supply, retailers may be constrained from moving supply for a number of reasons:

- Retailer structure: While a limited amount of product can be imported, importing a significant portion of a business is complex and requires a significant change in the business model of some retailers and wholesalers. Firstly, it necessitates having a central distribution centre to which suppliers can deliver. Moreover, it is costly and logistically difficult for a UK supplier to transport goods to retail outlets across the ROI. The head office may not be able to offer retailers without a central distribution centre the same quality of service that is offered by the ROI office or distributor. While still relatively complex, it is easier for a retailer that has an established central distribution system to import products into the ROI.

[29] "*Tesco Ireland reports sales of €3.1bn*" The Irish Times 21/04/09 available at www.irishtimes.com

- Promotions: Sourcing from further afield may be accompanied by promotions designed around the consumer taste preference of that country, which is unlikely to match the taste preference of the ROI consumer. In addition, negotiating supply from, e.g., the UK, may result in a loss of promotions and a shift towards EDLP pricing. Retailers state that promotions are an important aspect of driving sales and footfall in the ROI.

- Legal barriers to importation: There may be legal barriers to importation such as trade marks or licences. For example, over-the-counter medicines can only be imported by licence holders. Similarly, Jacobs Fruitfield has trademarked products in the ROI that no one else can sell.

- Product design: Language, bar codes and product size may restrict retailers from sourcing from elsewhere. For example, bar codes of products sourced beyond the UK and the ROI may not be compatible with current scanning systems used by the ROI retailers. Products may not have English language labels – EU packaging requirements stipulate that products sold in the ROI must be in an official language – or the same product may have a different name or be a different size.

- Consumer tastes: For some product categories, such as fresh food, retailers are constrained from importing products due to consumer tastes and preferences. For example, meat may be sourced more cheaply from outside the ROI, but ROI consumers want Irish meat. In addition, there is some difference in "taste preference" between UK or NI and the ROI. One substantial grocery undertaking stated that the match rate of products on sale between NI and ROI is only about 50%.

- Product type: Generally, produce with a short shelf life is sourced by retailers from a local supplier, e.g. ready-made sandwiches and fruit and vegetables. In addition, fruit and vegetables are a complex food category to import, as their seasonality means that a large number of sources of supply must be used. This would be a logistically difficult exercise for a retailer to undertake. In addition, one retailer group alone may not have the volume requirements or the infrastructure to make it a worthwhile undertaking. Generally, fruit and vegetables are supplied to retailers via consolidators that source the produce and that have the infrastructure and volume to efficiently import products on retailers' behalf. Fruit and vegetables produced in the UK have the same seasonality as ROI produce and would reach the shelves only a day later. However, ROI consumers would have to be willing to switch from ROI produce to UK produce in order to make it feasible for retailers' or their fruit and vegetable suppliers to switch to UK produce.

4.70 For the above reasons, many smaller retailers and wholesaler-franchisors have been constrained from importing products themselves. Instead, some have begun to use UK and NI wholesalers that have the logistical and distribution capability to deliver products to ROI. There are also UK buying groups for independent retailers. One such buying group, Nisa, has an increasing membership of ROI retailers and smaller wholesalers. Retail members belong to Nisa and wholesale members to Nisa Today's. By joining Nisa, small retailers and wholesaler get the benefit of the economies of scale afforded to a large buying group. Furthermore, because the products come from the UK, they make exchange rate gains. Two recent members of Nisa are

Ardkeen Quality Food Store in Waterford and Nolan's Supermarket in Clontarf, Dublin.[30]

4.71 Many small retailers that are already affiliated to a wholesaler franchisor in the ROI would be constrained from joining a buying group such as Nisa. Instead, they are increasingly sourcing from the grey market,[31] travelling to wholesalers in NI to purchase cheaper stock and buying stock from so-called "white van men", who are intermediaries that purchase stock in NI and travel around selling to retailers in the ROI. While the larger multiples and wholesalers have also reported that they are sourcing some goods on the grey market, they cannot do it on a regular basis because the volumes they can get are insufficient to meet all their requirements and the market itself is unreliable.

4.72 The retailers and wholesalers' reaction to the impact of the STG depreciation is also largely dependant on the percentage of goods that they source or could source in the UK. For example, as noted at the beginning of this section, the discounters' reaction to the depreciation has not been significant because very few of the goods they sell are sourced from the STG zone. The majority of their goods are own-brand, and are sourced in mainland Europe and the ROI. The branded goods that they stock are difficult to replace if they cannot negotiate reductions from their suppliers, because generally they are favourite brands that are stocked to accommodate consumer tastes. However, discounters do not view these brands as "must have" brands but rather as attractive options for customers who like to buy some branded goods.

<u>Supplier Reaction</u>

4.73 All suppliers, whether indigenous suppliers, wholly-owned subsidiaries, third party distributors or own-brand/exclusive brand suppliers, reported that they are under pressure to reduce prices. The pressures from customers and consumers are both recessionary and currency related: they are looking for price reductions from suppliers due to recessionary effects and the explicit difference in prices between NI and the ROI. In addition, like firms across all industries and across all continents, suppliers are themselves under pressures to find cost savings as a result of the fall in demand attributable the recessionary and currency effects.

4.74 Suppliers reported to the Competition Authority that there is an unrealistic "sterling expectation" from customers and consumers alike, and that both groups are looking for and expecting better value. Suppliers must respond to these pressures or face losing business from (a) retailers sourcing product from elsewhere, (b) consumers not purchasing their product or (c) consumers going to NI to purchase the relevant product for less. Suppliers' responses have varied: some have decreased prices, some have increased promotions and some have done a combination. The degree to and speed with which suppliers have responded, and the depth of price decreases and promotions, has also varied. The extent to which responses can be attributed to the recessionary effect or the currency effect is difficult to separate.

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[30] For further information see http://corporate.nisatodays.com/pressoffice/generalpress/newmembersinroi

[31] Goods that are sold on the grey market are sold outside of the normal channel of distribution by companies, which do not have relationship with the producer of the article. This mode of distribution while legal is unregulated and probably not intended by its producers.

4.75 The degree to which suppliers have responded to these expectations and the way in which they can respond is affected by:

- Ability: The ability of ROI offices of international brands and third party importer distributors to negotiate price reductions with the head offices of brands. The extent to which this is possible is dependent on the degree to which a product cost base is made up of STG and is affected by currency fluctuations; and,
- Choice: Whether the supplier chooses to reduce prices and/or to react in an alternative manner, e.g., to increase promotions.

4.76 A supplier's ability, whether it is a wholly-owned subsidiary of an international brand or a third party importer/distributor, to pass on price reductions will depend upon its ability to negotiate price reductions with the UK office.

4.77 Most ROI offices of international brands purchase product through the UK office and are invoiced in EURO. The price the ROI office pays to the UK office for product is set internally and will depend on the rate at which the currency has been hedged. International brands manage currency risk by hedging and setting internal company exchange rates. Therefore, the price the ROI office pays does not automatically mirror the currency exchange rate. In order for the ROI office to benefit from the depreciation of STG, they must attempt to renegotiate the price its pays for product with the treasury department of the UK office.

4.78 As mentioned above, international branded companies monitor the price corridor to ensure that the differential between the Euro zone and the STG zone is not so wide as to encourage retailers to by-pass local offices and source elsewhere. The depreciation of STG has substantially widened the price corridor and increased pressure on ROI offices to close the gap and to renegotiate the prices they pay for products. At the same time, the STG depreciation has reduced the price/margin international branded companies are getting for their products in the UK.

4.79 Some ROI offices have been successful in this regard and have accordingly reduced their prices to retailers. However, the extent to which international branded companies reduce prices is affected by the extent to which their cost base is made up of STG. Similar to retailers and wholesalers, the reaction of suppliers to the depreciation of STG is largely dependent on the number of its transactions that take place in STG. While supply of international branded products into ROI mainly comes from the UK, the product may have been manufactured outside the STG zone, or if it was manufactured in the STG zone, the cost of product may be based on substantial EURO costs, for example, the purchase of input material such as sugar. Thus the proportion of a supplier's cost of product that is STG-based will vary, and will affect the benefits they have received from the STG depreciation and consequently can pass on to retailers.

4.80 Similarly suppliers who have a large proportion of their costs, such as new materials in EURO, are experiencing internal pressure to increase prices to claw back these cost increases. However, due to the recession in the UK price increases are fiercely resisted by retailers and consumers.

4.81 Other ROI offices of international brands have been less successful in renegotiating prices and have had to wait a period of time for new "hedged" rates. International branded companies are also negatively affected by the STG depreciation as their EURO outflow has increased, i.e., the cost of product and/or input costs coming from EURO countries into the UK has substantially increased. Therefore, internationally branded companies are under pressure not to reduce prices into ROI, a source of EURO inflow. They are also under pressure to increase prices in the UK in order to recover costs. Price increases in the UK would also narrow the price corridor.

4.82 The ROI offices that cannot renegotiate upstream prices have reacted by increasing promotions to compensate or by slightly reducing prices in the expectation that they will get a new internal exchange rate. This reduces the net price to retailers, but it also reduces the supplier’s margins and/or ability to spend on advertising.

4.83 It is more difficult for third party importer-distributors to renegotiate their prices with the UK office. Third party importer-distributors are not part of the internationally branded company, and thus it is likely to be more difficult for them to renegotiate prices with their upstream supplier. An international branded company has less incentive to reduce prices to a third party distributor, as it still gets the sales and margin if the retailer by-passes the third party distributor and goes straight to the UK office. By contrast, if the retailer by-passes the ROI office of the brand, the branded company still gets the margin but its fixed cost of having a physical presence in ROI is under-utilised.

4.84 Third party distributors are increasingly being by-passed by the retailers. The response of suppliers to third party distributors has generally been to increase promotional activity rather than to reduce prices. One third party distributor contended that it has not been given the resources by the brands it represents and so it is steadily losing customers. Other third party distributors stated that they had foreseen grocery retailers by-passing them and are gradually moving away from the food market and or expanding their portfolio towards complex products, e.g., products that are logistically easier to import such as small health and beauty products.

4.85 Suppliers whose products are mainly sourced in mainland Europe have not benefited from the fluctuations in exchange rate. For example, for fruit and vegetable suppliers the STG effect has been minimal. The majority of fruit and vegetables is sourced in the ROI or mainland Europe; very little produce is sourced in the UK. Therefore, the majority of transactions relating to fruit and vegetables take place in EURO. One fruit and vegetable supplier did not seem to be affected by customers going to NI because the depreciation of STG has meant that fruit and vegetable prices have in fact risen slightly there.

4.86 The ROI operations of Kellogg’s provide a good example of how all of these variables affect a company’s response. Kellogg’s who are manufacturers in the UK, passed on the exchange rate difference to retailers and publicly announced its action. It negotiated with the parent company in the UK and consequently got a price reduction. The depreciation of STG also warranted a price increase in the UK and this was passed through. Kellogg’s stated that it passed through the STG depreciation for a number of reasons. Firstly, the price differential had become so apparent to consumers that the company felt if prices did not drop it would lose sales to NI. Second, it did not want the brand’s reputation to be damaged by having consumers think that it was the cause of the differential. Kellogg’s stated that its price reduction was passed on by retailers to consumers in full. Third, it realised that the top vertically-integrated retailers and wholesaler-franchisors have the necessary distribution infrastructure to import product from elsewhere quite easily. Kellogg's had noticed an increase in parallel imports, but once it reduced its prices, most of its customers came back to it.

Choice – Price vs. Promotions

4.87 Suppliers may prefer promotional activity to a reduction in prices for a number of reasons. First, as outlined above, suppliers may not be able to meet the "sterling expectation", and so promotional activity is an alternative means by which to decrease the net price to retailers and consumers, thereby bridging the gap between the STG price and the EURO price.

4.88 Second, as promotions are a traditional element of pricing in the ROI, promotions drive sales and footfall. Retailers prepare annual promotional plans and suppliers make promotional proposals based on these. Increasingly, suppliers are participating in their retailers' promotional cycles, especially the "ends of aisle" promotions, and offering "deeper" promotions.

4.89 Thirdly, suppliers often prefer promotions to price reductions as this ensures that consumers get all the benefit. A reduction in price is not guaranteed to be passed on to the consumer, whereas promotions go directly to the consumer. Retailers and suppliers told the Competition Authority that consumers are reacting to deeper promotions, and in particular they are reacting more to promotions on single units rather than traditional promotions, for example, "50% off" or "buy-one-get-one-free", versus the traditional promotions of "33% off" or "three for two" that consumers saw on the shelf a year ago. This is a recessionary effect, and suppliers contend that UK consumers are also reacting more to promotions. In addition, those suppliers that source mainly from mainland Europe and so are not benefiting from the currency fluctuations are also experiencing increased demand for promotions.

4.90 Lastly, international branded companies may be reluctant to reduce prices into the ROI due to the volatility of the exchange rate. If they reduced prices and STG then began to appreciate again, it would be difficult to renegotiate back a higher price.

Concluding Comment

4.91 This chapter has described the supply chain associated with grocery retailing in the ROI. It considered how the nature of competition in the sector has contributed to price differences between the ROI and NI and how it has influenced the way that operators in the supply chain have responded to the changed economic circumstances.

4.92 Apart from cost of doing business differences between UK and the ROI, the Competition Authority have found that a number of other factors have contributed to the price differential between the ROI and NI. First of all, the retail level of the grocery supply chain and the wholesale level are more concentrated than in NI. This concentration ultimately means that consumers have less choice to shop around, and consequently do not get as much value for money as they would if there were greater competition in the grocery sector. The retail sector in the ROI has also been concentrated at a time when ROI incomes have been higher than incomes in NI. ROI consumers have thus tended to be less price sensitive in recent years and so less eager to shop around. This has reduced pressure on retailers to price aggressively.

4.93 Secondly the distribution system in the UK is more efficient than the distribution system in the ROI. The UK distribution model is built on fully developed central distribution systems which enable retailers to deliver a variety of groceries to their retail outlets in a single visit. ROI retailers and wholesalers have varying capabilities to do this and there are considerable differences in the sizes of the networks they control, with Tesco by far having the most efficient system. NI is part of the UK market and uses the distribution structure of the UK. With a few exceptions, grocery retailers in NI do not use the ROI offices of international brands or third party distributors in the ROI. Thus, retailers in NI benefit from the efficiency of the UK distribution system and this is reflected in their cost of product.

4.94 Finally, the difference in the planning regulation system between the ROI and NI has had an impact on the size, type and location of grocery retail outlets in the ROI. The Retail Planning Guidelines prevent large scale low cost grocery retailers that operate in NI, such as Asda, from opening stores in the ROI without significantly altering their business strategy and the cost of product they can offer ROI consumers.

4.95 For the majority of retailers, wholesalers and suppliers, the depreciation of STG coupled with the effects of the recession, has had a significant effect on their business operations in the ROI, with most seeing reduced sales. Consequently, retailers and wholesalers have reported that they are working to reduce their cost base and that they have put pressure on their suppliers to reduce supply chain costs. This has resulted in some operators completely altering their business strategy in the ROI. For others, the reaction has been less extreme. For example, the discounters have seen increased sales in the ROI in recent months. As these retailers import most of their groceries from mainland Europe, they have not been affected as greatly by the STG depreciation as other operators.

4.96 Some retailers and wholesalers are in a better position than others to react to the depreciation of STG. This has much to do with their buying power, their central distribution capabilities and their ability to substitute a supplier’s product. We have found that by exercising their purchasing strength, larger retailers and wholesalers have been able to obtain reduced prices and more promotions from suppliers than the smaller operators. Where they have not been able to achieve lower prices, retailers have taken different paths.

4.97 Tesco has announced that it is by-passing ROI offices of suppliers and third party distributors by moving to the UK for direct supply for many grocery products. It can do so because it has a centralised distribution system in place to facilitate direct imports on the required scale. Other retailers and wholesalers that do not have the distribution capability to do this have taken other routes. Some have instead increased purchases from NI wholesalers and UK buying groups or increased purchases on the grey market. Others have tried to substitute the product with another brand depending on whether or not it is a “must-have” brand.

4.98 As a result of the actions of retailers and wholesalers, the suppliers are being placed under significant pressure to reduce their prices. Suppliers of groceries have generally reacted by: (a) reducing prices, (b) offering more promotions or (c) a combination of both.

4.99 A supplier’s ability, whether a wholly-owned subsidiary of an international brand or a third party importer-distributor, to pass on price reductions depends upon its ability to negotiate price reductions with the UK office. The STG depreciation has substantially widened the price corridor and increased pressure on the ROI offices to close the gap and to renegotiate the cost they pay for product from the parent company. Some ROI offices have been successful in negotiating the reduction and in turn have reduced their prices to retailers. Others have been given more discretion to increase promotions. Some suppliers prefer to give deeper promotions to ensure that the price drop goes fully to the consumer, and because they do not want to renegotiate a price increase with retailers if STG begins to appreciate against the EURO again. Ultimately, the extent to which international branded companies can reduce prices without lessening margin is affected by the extent to which a supplier's cost base is made up of STG.

4.100 Third party importers-distributors have found it more difficult to renegotiate prices with UK offices. An international branded company has less incentive to reduce prices to a third party distributor, as it still gets the sales and margin even if the retailer by-passes the third party distributor and goes straight to the UK office. The ROI distributor's main selling point in the past was that it understood the local market and so could target promotions at consumers that it knew would respond and could provide deliveries direct to store. However, in the current economic climate, the retailers and wholesalers that they have served are no longer renewing contracts or signing new ones if they cannot get a reduction on price. In this case, the parent company is not reacting to the loss of sales in the ROI because sales are being picked up in the UK. The ROI distributor instead is suffering.

5. IMPORT AND DISTRIBUTION: CLOTHING

Introduction

5.1 This chapter considers the clothing supply chain, where "clothing" refers to men's, ladies' and children's clothing, and sports and leisurewear, but excludes footwear.

Products

5.2 In the Consumer Price Index (CPI), clothing is made up of a variety of goods and services, such as men's, ladies' and children's clothing, sports and leisurewear, and services such as laundry and dry cleaning, dress hire and alterations. Together these have a consumer expenditure weight of 4.45. For the purposes of this chapter clothing does not include footwear and clothing services. Clothing, excluding footwear and services, accounts for approximately nine per cent of the goods base of the CPI.

5.3 Clothing brands differentiate themselves in terms of price, quality and design. For the purposes of the rest of this chapter clothing products will be categorised as:

- High range designer brands: These brands are committed to luxury, style, and quality. These iconic designer brands, typically purchased by the well-off, include for example, Gucci, Dolce & Gabbana and Giorgio Armani. Most of the high range designer brands have a portfolio of brands; for example, Gucci, Alexander McQueen and Yves Saint Laurent are all brands of the Gucci Group.
- Middle range high street brands: These brands bring designer trends to the high street; they are design-led and are sold at high street prices. They include such well-known names as United Colours of Benetton, Sisley, River Island, Nike, and Adidas. Clothing companies may own more than one middle range high street brand; for example, Aurora Fashions owns Karen Millen, Oasis, Coast and Warehouse.
- Low cost brands: Low cost brands offer contemporary designs and current fashion at low prices, such as Penneys and Dunnes Stores.

Retail Level

Types of Operators

5.4 There are three types of clothing retailers:

- Vertically-integrated Retailers;
- Independent Retailers; and
- Department Stores.

5.5 Vertically-integrated retailers operate wholly-owned retail outlets and sell only the clothing brand of that company, e.g., River Island, Topshop, Wallis and Warehouse. Vertically-integrated retailers tend to have an international presence. Many high range designer brands, middle range high street brands and low cost brands are vertically-integrated. They are located on main streets and in shopping centres; in addition high range designer brands and middle range high street brands sell their clothing ranges in department stores. Some vertically-integrated grocery retailers, such as Dunnes Stores, Marks & Spencer, and Tesco also feature in this category.

5.6 Independent retailers sell a selection of brands and are independent of the brands they sell. Independent retailers can take many forms. Their stores tend to sell middle range high street brands, however some may sell high range designer brands. Independent retailers tend to specialise in one type of clothing, such as ladies' clothing, bridal, sports clothing, or menswear, and generally provide their customers with more choice and variety for those categories. Independent retailers may own and operate a chain of stores under a common fascia and are typically known as "branded resellers". For example, Champion Sports and Lifestyle Sports are branded resellers. Other independent retailers may be small local boutiques. Independent clothing stores are mainly located on the main shopping street in towns and cities and in shopping centres.

5.7 Department stores are quite different. They sell a wide variety of products from clothing to homewares, and electrical appliances to cosmetics. Department stores include, e.g., Arnotts, Debenhams, House of Fraser, Clerys and Brown Thomas. In terms of clothing, department stores tend to sell high range designer brands and/or middle range high street brands; low cost brands are rarely sold in department stores. Department stores are generally located in central locations in cities and large towns.

5.8 A department store is a hybrid retailer. As detailed in subsequent paragraphs, branded clothing is available in their stores from vertically-integrated companies locating in the store through a "concession" arrangement and/or is "own-bought" and resold by the stores themselves. A few department stores also sell own-brand clothing labels. For example, "Début" is a Debenhams own-brand clothing line.

5.9 Concession arrangements occur where vertically-integrated branded clothing companies have an agreement to sell in a dedicated area of a department store. Many of these are the same brands sold in high street vertically-integrated stores. In effect, the department store is the concessionaire's landlord and earns a rent or commission from the concession. Therefore, the department store has less risk as it does not own the concessionaire's stock, i.e., it is not a reseller. However, a department store's commission is affected by fluctuations in sales. The actual stock and the profit from sales, excluding the commission, belongs to the "concession", i.e., the vertically-integrated brand.

5.10 Own-bought clothing is branded clothing purchased by the department store from the manufacturer or its agent or distributor for resale. For own-bought clothing the department store bears the risk. Own-bought retailing is therefore similar to the arrangement described for independent stores, where a selection of brands is sold in the same store; the difference being that independent stores typically specialise in one type of clothing, whereas department stores sell different types of clothing, i.e., menswear, ladies' wear, children's clothing and so on.

5.11 Although clothing may be retailed through department stores under different arrangements, it is not obvious to the consumer which brands operate under each arrangement, i.e., whether the brand is sold under a concession or own-bought arrangement, as their presentation is seamless. The percentage of clothing that is own-bought versus concession varies across department stores. In general, men's clothing tends to have more own-bought arrangements.

5.12 The clothing retail landscape in the ROI is, in comparison to grocery retailing, quite fragmented. There are a large number of operators in the ROI. Department stores are large in number and include Brown Thomas, Harvey Nichols, House of Fraser, Debenhams, Arnotts, Clerys and Heatons. Harvey Nichols and House of Fraser have only one store in the ROI, Arnotts have two, Brown Thomas and Clerys both have four stores, Debenhams have 11 stores and Heatons has 81 stores in the ROI. There are many vertically-integrated middle range branded retailers who operate chains in the ROI including River Island which has 20 stores, Topshop which has 16 stores, Oasis which has 32 stores, A|Wear which has 25, Karen Millen and Warehouse which have 9 stores each and Monsoon has 18. In addition, there are independent stores present in the market; two sportswear examples are Champion Sports with 21 stores and Lifestyle Sports with 62 stores in the ROI. One of the biggest low cost clothing retailers in the ROI is Penneys with 38 stores. Dunnes Stores is also a major retailer in the clothing sector in the ROI.

Nature of Competition

5.13 Clothing retailers compete in a variety of ways. Retailers compete in terms of brand, value, and location.

Brand Competition

5.14 At the retail level brand competition tends to differ by type of clothing retailer. Vertically-integrated international brands compete at a high level by promoting their branded product internationally. This is discussed further later in this chapter.

5.15 Independent retailers and department stores compete through the range of brands and products they stock in their stores, and by building store image. In order to get the brands they want into their store, department stores further compete on the commission rate, location in store and merchandising. Branded reseller chains, for example, sports retailers, also compete on store reputation through store advertising and promotions etc. Department stores compete on store image by creating a "shopping experience" and through promotional activity to attract footfall.

5.16 The past decade has seen a big increase in the number of brands of clothing available in the ROI market. Examples of new entrants include Zara, H&M and Ted Baker.

Value

5.17 Retailers within the same clothing categories compete on value, i.e., the combination of price, design and quality. Clothing retail competition tends to start with competition among different brands within the same range, be it high range, middle range or low cost. Once a brand positions/markets itself within one of the clothing categories, it competes mostly with other brands within the same range by pricing at a level that reflects the quality, design and brand image that has been created.

5.18 In terms of pricing, vertically-integrated retailers operate a system of national pricing and thus at a retail level compete more on quality of service, shop fit etc. Vertically-integrated brands are increasingly also offering on-line shopping.

5.19 Low cost brands primarily compete on price by offering contemporary design and current fashion at low prices. The ultimate goal of these brands is to set their prices low. Consumers are looking for value for money when purchasing these brands.

Location

5.20 Location is of critical importance in clothing retail. In the ROI, despite the growing number of out of town shopping centres, the main street is still a major draw for clothing retail. Thus, there is demand and competition among all clothing retailers for prime main street locations, such as Grafton Street and Henry Street in Dublin, Patrick Street in Cork, O'Connell Street in Limerick, and Shop Street in Galway.

Comparison with NI

5.21 Retailer types in the UK and NI are similar to those in the ROI. Most major UK high street clothing retailers operate in the ROI. For example, Marks & Spencer, Debenhams, Topshop, Oasis, Karen Millen and Monsoon are all present on ROI and UK main streets. With the entry of UK department store Debenhams in mid-2006, the penetration of UK retailers in the ROI increased.

5.22 Vertically-integrated international clothing brands sold in the ROI are similar to those in the UK. Some UK-based brands are very popular and sold in both jurisdictions, e.g., Topshop, Next and Karen Millen. Some non-UK based international brands are also sold both in the UK and the ROI, for example H&M and Zara. Some ROI brands have retail stores in mainland UK and NI, e.g., Penneys, known as Primark in other jurisdictions, and Dunnes Stores. Outlets of these brands in the ROI and the NI are similar in design and layout. Independent retailers and department stores can differ somewhat between the ROI and NI. However, some ROI independent retailers have stores in both jurisdictions, for example, Lifestyle Sports has stores in NI. Some UK retailers and department stores operate both in the ROI and NI, e.g., Debenhams and House of Fraser.

5.23 Although the international brands sold in both the ROI and the UK are similar, and some independent stores and department stores operate in both jurisdictions, the scale in each jurisdiction is quite different. Retailers operating in the UK tend to be larger and therefore can offer a broader product range. The UK is a market of 60 million people compared to four million people in the ROI. Therefore, there are more brands and bigger stores in the UK.

Supply Chain

Types of Operators

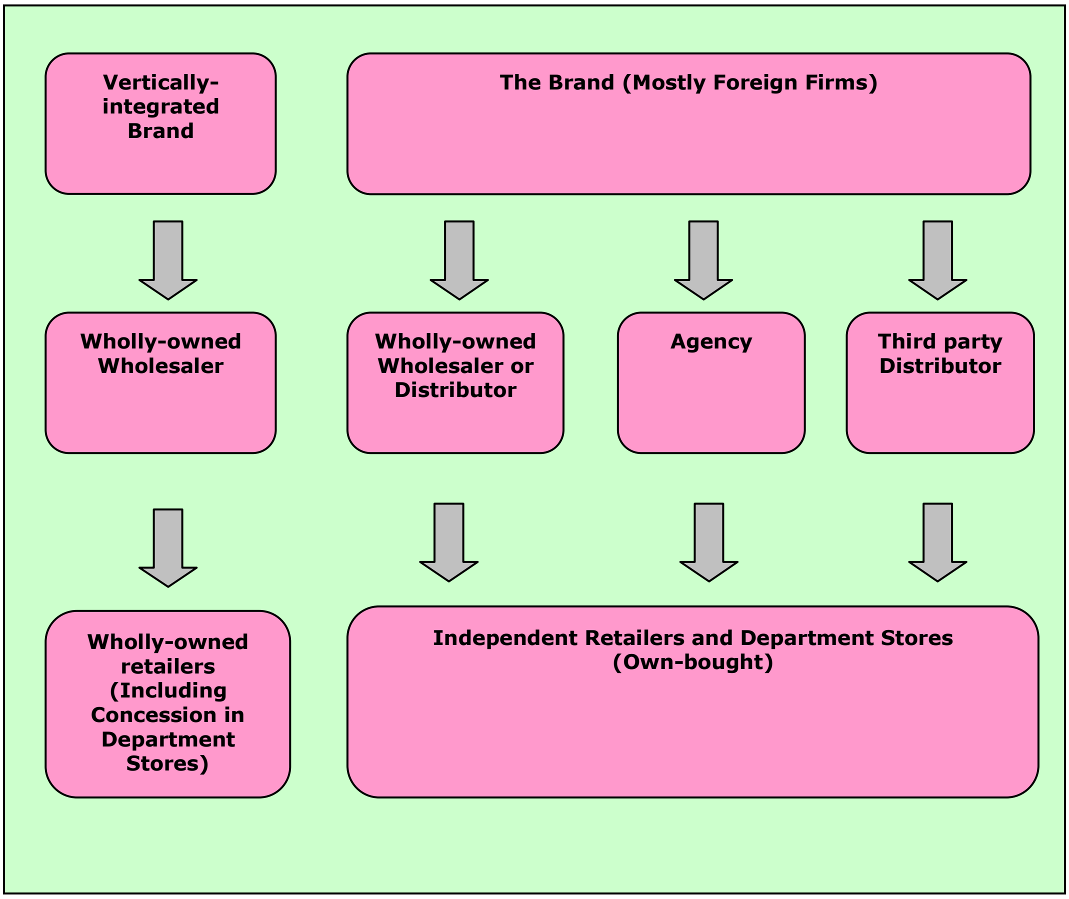
5.24 The supply chain and, in particular, distribution for each type of clothing retailer and supplier, tends to vary. Figure 9 demonstrates the most common channels of supply for clothing. Vertically-integrated branded companies supply clothing internally to retailers, while other branded clothing companies supply clothing through wholly-owned wholesalers, agencies or third party distributors.

5.25 Clothing is typically designed by the brands themselves and manufactured mostly in the Far East, and sometimes in Europe or

South America. In certain instances, the manufacturer is owned and operated by the brand and in other instances it is outsourced by the brand. Some brands use buying teams or groups to source their products around the world and are not aligned to, or contracted, with any manufacturer; they may also have different buying teams for different markets. Occasionally, brands outsource part of their manufacturing operations to distributors.

5.26 Most of the ladies' clothing sold in the ROI is sourced from foreign brands. There are only a few ROI suppliers left, such as Penneys and Dunnes Stores. From the information supplied by some department stores, of their top ten concession and own-bought suppliers, approximately half are UK based suppliers.

Figure 9: Clothing Supply Chain



5.27 Vertically-integrated branded retailers and concessions in department stores source their product from their parent company. Vertically-integrated brands internalise the supply, wholesale and retail aspects of their supply chains. The retailers and wholesalers are part of the branded company and operate under the instruction of the parent company. The brand supplies its products to its stores and concessions in department stores. There is no intermediary or third party involved in the supply chain. For example, River Island and Topshop operate a vertically-integrated supply chain.

5.28 Own-bought clothing suppliers to independent stores and department stores, use wholly-owned distributors, agencies and/or third party distributors in the ROI or the UK. Which avenue a supplier takes ultimately depends on how the branded company wishes to operate its distribution and the benefits or service each distribution type can offer.

Large multinational brands tend to have wholly-owned wholesalers based in the UK/ROI.[32] Some brands have two separate wholly-owned wholesalers for the UK and ROI; others have one wholly-owned wholesaler for the two jurisdictions. In some cases, rather than an office, the brand has a country representative, an employee of the brand, to manage the supply. Most wholly-owned wholesalers use selective distribution arrangements, i.e., supply to a number of different independent stores and department stores. For example, Nike Ireland is a wholly-owned wholesaler of Nike in the ROI. Stores in the ROI that sell Nike products are supplied by Nike Ireland directly. In the case of some brands, there may be an exclusive distribution arrangement whereby one retailer and its stores, or a chain, receives exclusivity for the product in the ROI.

5.29 Some brands distribute through independent agents. The agent places the order to the brand on behalf of the retailer and receives a commission in return for placing the order. The agent does not buy the product and, therefore, in some sense the agent is an arm of the brand. Retailers may negotiate terms and prices either with the agent or the branded supplier; at what level the retailer negotiates terms varies depending on retailer size. Most agents distribute more than one brand, for example Sunil Shah is an agent in the ROI for Tommy Hilfiger. Branded companies and retailers tend to prefer not to deal with a "middle man", therefore, these types of agency agreements are rarely found in the market.

5.30 Some brands distribute their product through third party distributors. Third party distributors buy products from the brand and resell it to retailers in the ROI, i.e., they are the customers of the brand and have an account with them. Therefore, third party distributors take on a business risk. For example, Warnaco distribute Calvin Klein Underwear in the ROI. Distribution downstream to the retail level can be either an exclusive or selective arrangement. However, given the preference of not dealing with a "middle man" distributors are rarely found in the market. Most of the brands sold through third party distributors are lesser known brands.

Nature of Competition

5.31 Ultimately suppliers compete for consumer demand by building brand awareness and through interactions with retailers. However, clothing suppliers compete mostly at the brand level. Brand competition is a critical feature of clothing competition at supply level. Brands compete by establishing a brand that reflects the image and clothing category in which they wish to operate; high range, middle range or low cost. They will also price their product in a way that reflects the clothing category and brand image they have created. Where they sell through independent retailers and department stores, they generally choose retailers whose own image is aligned to that of the clothing brand's image.

5.32 High range brands compete with each other by establishing a desirable brand through fashion shows, sponsoring big international entertainment events etc. Fashion weeks, held in many different cities, are important events for high range brands. In the fashion industry designers compete with each other to try to take the lead on the season's fashion trend, i.e., be the trend-setter.

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[32] Department stores met by the Competition Authority during the course of this Report stated that the majority of their top ten suppliers are wholly-owned distributors.

5.33 Middle range brands compete with each other through advertising, sponsoring different events, or selling celebrity fashion lines using celebrity fashion icons to represent the brand. For example, Topshop stocks a Kate Moss range and sports brands such as Nike, Adidas, Puma compete through advertising and using well-known sportsmen and women to represent the brand; they also sponsor different sports events and/or teams to promote their brand image and awareness.

5.34 Suppliers to low cost retailers (i.e. manufacturers in the Far East and South America etc.) compete on price and quality

5.35 Agencies compete by providing competitive commissions to the brands. Third party distributors also compete with each other, by the services they offer, guaranteed sales volume and other commercial activities.

5.36 Suppliers also compete in their interactions with retailers, in terms of space, commission, and location in the store. For example, concessions in department stores will compete for the best location in the store, i.e., where there is the most footfall. Suppliers also compete to have their products sold in the signature stores in a city.

Comparison with NI

5.37 Most brands sold in the ROI are also sold in NI, and therefore the majority of the suppliers are the same for both NI and the ROI retailers. The basic supply channels are also the same for the UK/NI and the ROI.

5.38 For vertically-integrated brands, the suppliers are the same for retailers in NI and the ROI, i.e., the brand supplies its own stores/concessions internally. For brands that have two separate wholly-owned distributors for the UK and the ROI, retailers from NI and ROI source the brand from distributors in their own jurisdictions. For brands that have one wholly-owned distributor for UK and the ROI, retailers from NI and the ROI source that brand from the same distributor.

Supplier Price Differentials

5.39 In 2000 ROI clothing and footwear prices were seven per cent lower than in the UK; in 2007, ROI clothing and footwear prices were still seven per cent lower than in the UK (see Chapter 2). In January 2009 an NCA survey found that clothing prices were considerably higher in the ROI. One clothing example is that an identical dress from Monsoon cost £85 in the UK compared to €130 in the ROI.

5.40 This suggests that, despite the rising cost of doing business, the level of competition in clothing and footwear in the ROI (as well as the expansion in the volumes sold here) kept prices from rising relative to the UK until 2008 when the STG/EURO exchange rate changed significantly.

Impact of STG Depreciation and Reaction of Retailers and Suppliers

5.41 The recession and depreciation of STG, coupled together, have significantly impacted upon the clothing retail business. Retail sales for textiles and clothing declined by 5.3% in the year to December 2008. Increasing numbers of clothing retail chains are going into administration in the UK, due largely to the global financial crisis. Some ROI retailers are closing stores.

5.42 The effect of the reversal in the price gap between the ROI and the UK has been that footfall and sales in the ROI have reduced significantly due to consumers changing their behaviour. Consumers' shopping behaviour has changed in a number of ways:

- Consumers are reducing the volume of purchases they are making. This is partly a reaction to the practice of "dual-ticketing". Dual ticketing is where many retailers that sell in both EURO and STG areas display the price of the product in both currencies. With the depreciation of STG this practice explicitly highlights the price difference between NI and the ROI and puts consumers off buying;
- Consumers are increasingly buying from the STG zone by going to NI for their clothing purchases, or shopping on-line. A large number of ROI stores are also present in NI border towns such as Enniskillen and Newry, (e.g., Marks & Spencer, Debenhams, Topshop, Oasis, A|Wear, Warehouse, and Monsoon). In a recent press article, Debenhams stated that "*Northern Ireland performed strongly as shoppers in the Republic take advantage of the strength of euro. Conversely, there are signs of weakening in the Republic in line with the severe economic down-turn being experienced in that market*"; [33] and,
- Consumers are switching. Low cost branded stores do not appear to have been as negatively affected as other stores; what they have lost in terms of consumers reducing purchases overall in the ROI, they have gained from consumers switching from mid-range clothing to their low price/high value stores. In addition, ROI retailers contend that consumers are switching to retailers that source their product in STG.

Retailer Reaction

5.43 The depreciation of STG has had a significant effect on retailers. Retailers contend that business in 2009 is down by 20%. The depreciation of STG and the global recession have occurred simultaneously and it is therefore not clear how much of the decline in sales is attributable to the recession and how much to the STG depreciation.

5.44 In response, retailers have tried to cut costs by reducing the cost of doing business and the cost of product. They have reduced the cost of doing business by reducing opening hours, working hours and pay.[34]

5.45 With respect to cost of product, retailers can either try to renegotiate a price with their supplier, switch supply by switching brands, or by-pass the current branded supplier and source product from an alternative supplier.

5.46 The extent of exchange rate pressure and reduced footfall has driven retailers to go back to their suppliers, be it the manufacturer, wholly-owned wholesalers, third party distributors or an agency, requesting price reductions. Renegotiating prices with suppliers may be difficult due to the seasonality of clothing retail and limited buyer power of ROI stores.

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[33] Irish Examiner, "Debenhams boosted by cross-border shopping", 24 April 2009
[34] RTÉ News, "'Stores cut opening hours to cut costs"', 18 March 2009

5.47 Generally, retailers organise their stock for at least the following two seasons, or perhaps even for the coming year. Thus retailers decide on their stock and volume of purchases between six months to a year in advance; simultaneously price for the product is agreed typically in EURO. In addition, in order to minimise currency risk, some retailers may hedge their currency at that time. Thus, due to these agreed prices and volumes, retailers are finding it difficult to renegotiate price with their suppliers. Retailers will, at the time of agreeing price with their supplier, set their retail prices, and thus in instances of dual-ticketing, STG prices and EURO prices will be set to reflect the price at which they bought the product. Given that this may be done a number of months in advance, by the time product appears on the shelf, exchange rates may have changed. This effect should diminish as retailers purchase the next round of stock which will be based on more recent exchange rates.

5.48 The ability of a retailer to negotiate price reductions will depend also on its importance to the supplier, i.e., the extent of its buyer power. ROI retailers are typically small in international terms.

5.49 Switching brands may not be a possible option if the brand is a "must have" brand for the retailer, for example, consumers expect all sports stores to have certain international and Irish sports brands. It will negatively affect the retailer's image if it does not have the must have brands for certain categories of clothing.

5.50 Retailers, independent stores and department stores contend that sourcing product by by-passing the current source of supply, i.e., the wholly-owned wholesaler, third party distributor or agency, is difficult. They state that the head office or equivalent UK distributor will direct the retailer back to the designated ROI distributor. Most international brands use wholly-owned wholesalers, thus the alternative source of supply is simply a different arm of the same company. In some cases retailers have been successful in renegotiating to pay STG prices but in most cases this has been refused.

5.51 Retailers' attempts to get better prices following the STG depreciation may be more difficult for ROI-operated retailers. If they are not already doing so, UK retailers that operate in both the UK and ROI may be able to benefit from sourcing product for their ROI stores in STG through their UK supply chain. Thus, any potential benefits arising from the STG depreciation may not be spread evenly across retailers.

5.52 For department stores and independent retailers, alternative sources of supply, such as the grey market, may be an option. However, product from the grey market is seldom the latest fashion and may be limited in the range and sizes it comes in. It also has limitations in terms of consistency of supply, and thus may not be an adequate option.

5.53 The individual stores of vertically-integrated middle range retailers in the ROI, of which there are a large number, do not have any alternative option to source product, as they must source their product internally. STG and EURO prices in these stores are not set by the retailer but the head office of the brand and therefore they are constrained by the controlled supply channel in which they operate. These vertically-integrated brands are large international brands that operate on a large scale. The ROI likely represents only a small portion of their overall business.

5.54 Some low cost retailers are not experiencing as much difficulty in switching sources of supply as independent stores or department stores. This is due to the fact that they tend to be vertically-integrated and are not aligned with any one supplier but instead they source manufactured product from the Far East based on the best price, design, quality and range. These low cost retailers market themselves on price. Dunnes Stores and Penney contend that they have adjusted the price differential between their stores in NI and the ROI by reducing prices in both jurisdictions.

5.55 Despite the constraints faced by some retailers, they are reacting by re-pricing clothing, increasing sales/discounts and promotions, and trying to source new products that have more attractive price and quality characteristics.

<u>Supplier Reaction</u>

5.56 Suppliers' responses to increased pressures from retailers to reduce prices will depend on their ability and willingness to reduce prices.

5.57 Distributors of brands under pressure from retailers to reduce prices will themselves be limited in their ability to reduce prices to the extent that they can renegotiate a price reduction with their upstream supplier. Brands source product directly from their own, or contracted, manufacturers. This is often done in the Far East or other countries outside the STG zone and therefore they operate in a number of currencies. Supplier costs are therefore largely in EURO or currencies other than STG. In reality, UK suppliers may have a small portion of costs in STG and may not be able to pass on the current "sterling expectation" that exists in the market.

5.58 In addition, branded clothing companies tend to be vertically-integrated upstream through contracted manufacturers and downstream through wholly-owned retailers and/or distributors; due to this tight distribution arrangement, the seasonality, and likely hedging aspects of suppliers' operation, the extent to which they can quickly react to changes in currency fluctuations will be limited.

5.59 Overall, suppliers are being negatively affected by falling sales and the depreciation of STG and therefore they do not want to lose revenue in the ROI too. Some retailers stated that the STG depreciation warranted a price increase in the UK but that branded companies would find it difficult to increase prices in the UK because of recessionary pressures. The UK is a bigger market and it is riskier to increase prices in the UK. In addition, branded companies tend to operate across a number of jurisdictions. The ROI's population is smaller in scale in comparison to the UK and other jurisdictions in which the same brand operates.

Concluding Comment

5.60 Differences in price level between the ROI and the UK have to some extent always been present, and changes in the differences in price level arise, amongst other reasons, due to currency movements. In 2007, clothing and footwear prices in the ROI were lower than in the UK. By 2009 this situation had reversed, substantially.

5.61 The transparency of the price differential is observable due to dual-ticketing of clothing by some clothing retailers. The differential has also been highlighted by the NCA survey. The effect of the differential in price is driving consumers to change their shopping behaviour to the detriment of the majority of clothing retailers present in the ROI. Low cost clothing retailers however have not been as negatively affected;

what they may have lost in terms of reduction in consumer spending in ROI they have gained from price conscious consumers switching to them. Among other things, retailers have responded by increasing sales/discounts and promotions, and in some instances re-ticketing items to bring down the EURO price.

5.62 However, the extent of the response of retailers is limited by the extent to which they can reduce their costs of doing business, for example, reducing opening hours, and their cost of product. The ability to reduce cost of product is constrained by three elements; the seasonality of the clothing market, limited buyer power and the ability to switch sources of supply.

5.63 Clothing stock and prices are determined six to 12 months before they appear in store. ROI retailers are relatively small internationally.

5.64 Low cost retailers can easily switch sources of supply, though with a time lag. They are not aligned with any particular manufacturer and source product based on a mixture of quality and low price. If they are not happy with supply they will source it from elsewhere.

5.65 At the other end, vertically-integrated retailers operating in the ROI cannot switch supply and are constrained by the parent company's distribution arrangements. The stock available to these stores is purchased centrally; their ability to switch will depend on how quickly they can renegotiate price with their manufacturer or find another source of supply elsewhere.

5.66 Clothing retailers who resell a range of brands (independent retailers and department stores) also have limited ability to switch supply and find identical product elsewhere. They also have long term relationships with brands which they need to maintain. They are thus seeking price reductions from suppliers.

5.67 The extent to which these retailers can negotiate lower prices is dependent on their buyer power. UK department stores and branded resellers may be able to source supply in STG through their UK operations. In some instances ROI-operated retailers have been able to switch to paying in STG but in the main they have not. Thus ROI-operated retailers may be temporarily disadvantaged compared to retailers who buy in STG, e.g., any UK international owned department stores and branded resellers who buy in STG.

5.68 The instability of the EURO/STG exchange rates has had a significant impact on clothing retail in the ROI. International brands which manufacture outside the UK and sell to the UK will likely adjust their forthcoming seasons' prices in line with the currency fluctuations.

6. IMPORT AND DISTRIBUTION: PHARMACEUTICAL PRODUCTS

Introduction

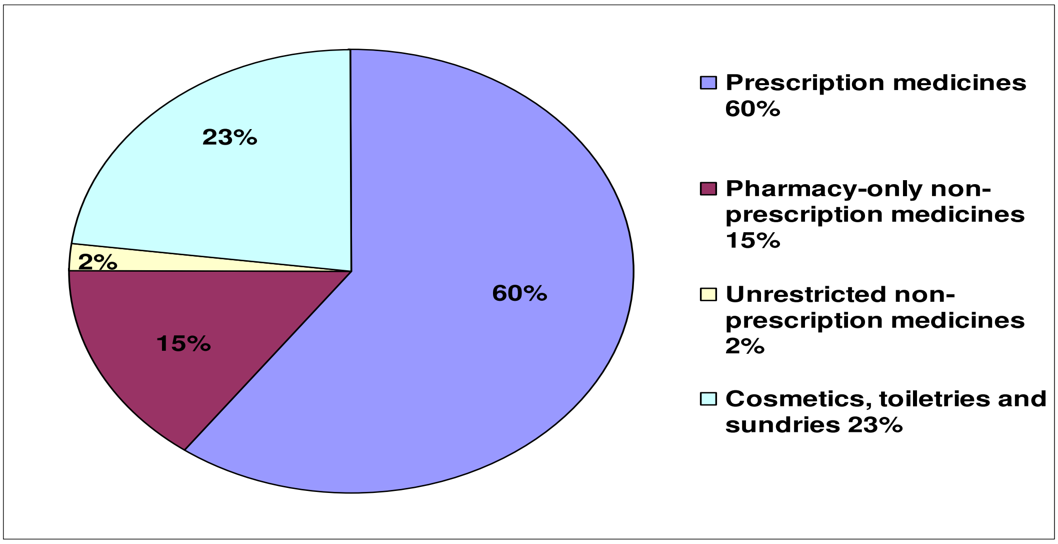
6.1 "Pharmaceutical products" is used here to refer to medicines available in retail pharmacies and other retail stores that require an Irish Medicines Board (IMB) licence to be sold in the ROI.

Products

6.2 A retail pharmacy provides services in respect of three main categories of pharmaceuticals: (a) prescription medicines; (b) pharmacy-only non-prescription medicines; and (c) unrestricted non-prescription medicines. Pharmacies also sell a range of non-medicinal products, often referred to as cosmetics, toiletries and sundries (CTS products).

6.3 Figure 10 below shows an estimate of the respective sales for these three categories in retail pharmacies in the ROI. It indicates that, typically, the dispensing of prescription medicines form the core business of pharmacies.

Figure 10: Retail Pharmacy Sales in the ROI



Source: Competition Authority, GEHE Merger Decision, 2002.

6.4 Pharmacy-only non-prescription medicines can only be sold in pharmacies, whether kept behind the counter or displayed on open shelves.[35] Unrestricted non-prescription medicines can be sold in any type of retail outlet (e.g., supermarkets and convenience stores) and thus pharmacies compete with other retail outlets for sales of these products.[36] Similarly, CTS products can be sold by a variety of non-pharmacy outlets.

[35] Although a previous prohibition on mail-order/internet sales was removed a number of years ago.

[36] Unrestricted non-prescription medicines include Alka Seltzer, Disprin, Gaviscon, Lemsip, Panadol, Strepsils, Dettol and TCP.

Retail Level

Types of Operators[37]

6.5 As of 31st March 2008, there were 1,521 pharmacies in the ROI. Retail pharmacies have traditionally been small, independent, single-location operations, but chains of pharmacies have become a more prominent feature of the ROI market.

6.6 In 2008, 55% of pharmacies were sole traders with pharmacy chains accounting for the remaining 45% of the market. However, a large percentage of these pharmacy "chains" are small in size - 57% of them operate between two and five stores. Only a handful of chains operate more than 20 stores nationwide; for example, McCabe's operate 21 stores mainly in the Greater Dublin region while Sam McCauley operates 23 stores predominately in the South-East and South West regions of the ROI.

6.7 By far the two largest pharmacy chains operating in the ROI are Unicare, with 71 stores, and Boots, with 42 stores. Both are foreign-owned. However, combined these chains account for only 16% of chain pharmacies and just over seven per cent of all pharmacy stores in the ROI.

6.8 A large percentage of pharmacies are located outside of major urban centres. In 2005, 37% of the total numbers of pharmacies were located in villages (less than 1,500 inhabitants) and small towns (between 1,500 and 5,000 inhabitants).

Regulation

6.9 Retailing of pharmaceuticals is highly regulated in the ROI, as in many other countries. Every medicine sold at retail level in the ROI must have a licence from the IMB. To get a licence, a medicine must be tested for safety, quality and efficiency. The licence will also dictate the information to be provided on packaging, the pack sizes that may be sold and whether the medicine should be classified as prescription-only, pharmacy-only non-prescription or unrestricted non-prescription.

6.10 Prices of prescription-only medicines and some non-prescription medicine are also highly regulated. The cost or "trade price" of prescription medicines is set by the State under an agreement with the Irish Pharmaceutical Healthcare Association (the "IPHA" agreement), which represents manufacturers of pharmaceutical products.[38]

6.11 Medical card holders and persons on the Long Term Illness scheme (LTI) pay nothing for medicines obtained on prescription. For medical card holders, the State reimburses the pharmacy in full for the trade price of the prescription medicine and pays a dispensing fee currently set at €3.59[39] upwards per item.[40] The dispensing fee for patients aged 70 or over is €4.54. Under the LTI scheme, the State reimburses the pharmacy in full for the trade price of the medicine plus a 50% mark-up on that price and a dispensing fee of €3.16 upwards per item.

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[37] Irish Pharmacy Union (IPU) Annual Report 2008. Available from: www.ipu.ie.

[38] The IPHA agreement covers medicines that are "prescribable and reimbursable" under State schemes, as listed in the GMS code book.

[39] Dispensing fee data taken from the "Report of the Independent Body on Pharmacy Contract Pricing", June 2008.

[40] If a pharmacy wishes to participate in the State-administered schemes, it must enter into a community pharmacy contract.

6.12 Residents in the ROI who do not have a medical card can register for the Drugs Payment Scheme (DPS) and they benefit if their expenditure on approved drugs, medicines and appliances for themselves or their families exceeds a monthly threshold (currently €100).

6.13 Under the current DPS reimbursement arrangements, the State reimburses the pharmacy in full for the trade price plus a 50% mark-up on that price and a dispensing fee of €3.16 upwards per item, less the monthly DPS patient's payment of €100. This is similar to the arrangement for the LTI scheme. Approximately 80% of the value of all prescription and pharmacy-only non-prescription sales is recouped from the State, making it the single largest buyer of these products in the ROI.[41]

6.14 Charges to private patients (i.e., patients who do have a medical card, do not qualify for the LTI scheme or do not spend more than €100 per month) are not regulated by the State and so pharmacies are free to charge whatever they like. However, it appears to be customary to charge private patients the trade price plus a 50% mark-up and a dispensing fee similar to the LTI and DPS pricing systems. Pharmacies often explain this by pointing out that it is not known at dispensing time whether the patient might reach the €100 monthly threshold and thus qualify for the DPS scheme. The margin on private prescriptions in the ROI is regarded as being one of the highest in the EU.[42]

6.15 Non-prescription medicines not covered by the IPHA agreement can be priced freely by pharmacies for public and private patients. However, it would again appear the custom to charge private patients the trade price plus a 50% mark-up and a dispensing fee if the product was supplied on prescription.[43]

6.16 The advertising of prescription drugs is prohibited, for health and safety reasons. Furthermore, as a professional rule, pharmacies are not permitted to advertise outside the confines of their premises.

Nature of Competition

6.17 Price competition between pharmacies with regard to pharmaceutical products is extremely limited. There are a number of reasons why this is so:

- Approximately 80% of the value of all prescription and pharmacy-only non-prescription sales are recouped from the State, making it the single largest buyer of pharmaceutical products in the ROI. The prices of all these medicines are effectively set by the State;
- It is customary for pharmacies to charge a 50% mark-up on all private prescription medicines. Every pharmacy knows that to deviate from this will encourage prices to fall. In the case of DPS patients, this is underpinned by a State guarantee of reimbursement of that degree of mark-up. Furthermore, it has been suggested that ROI pharmacies rarely stray from the recommended retail price (RRP) for non-prescription medicines;

[41] Irish Pharmaceutical Healthcare Association (IPHA) website. Available from: http://www.ipha.ie/alist/medicines-supply-and-reimbursement.aspx.

[42] Purcell, D (2004), Competition and Regulation in the Retail Pharmacy Sector.

[43] The Competition Authority (2002), GEHE Merger Decision, 2002. Non-prescription medicines can of course be bought without prescription but a doctor may also prescribe certain non-prescription medicines which (s)he feels are necessary for the patient and are reimbursable under the GMS or DPS scheme.

- Restrictions on advertising limit pharmacies incentive to compete with one another;
- Demand from pharmacy customers tends to be local in nature, as customers are generally not willing to travel long distances to obtain prescription and other medicines;and
- Pharmacies must dispense according to the prescription, thus their ability to influence demand is limited.[44]

6.18 It is for the sale of unrestricted medicines and CTS products that pharmacies face the greatest level of competition - from convenience stores, supermarkets and department stores.

Comparison with NI

6.19 While the ROI has a higher number of pharmacies per capita compared to most EU15 countries,[45] pharmacy chains in the UK and thus NI are of a much greater scale compared to the ROI. For example, Boots has around 2,500 stores in the UK and about 100 stores in NI. Lloyds Pharmacy has over 1,700 stores while the Co-operative chain has over 800 stores in the UK. It is also common for supermarket chains in the UK (e.g., Asda, Sainsbury's, Tesco and Morrisons) to have in-store pharmacies. In the ROI, the largest chain is Unicare with 71 stores nationwide.

6.20 Like the ROI, the Government in the UK is the biggest purchaser of prescription medicines and the prices of these medicines are highly regulated. However, the systems of State reimbursement for pharmacies (i.e. mark-up levels) in the two jurisdictions are different and difficult to compare.

6.21 Cheaper generic prescription drugs are used more frequently and own-brand pharmaceuticals are more commonly available in the UK.

6.22 It has been suggested that, compared to the UK, independent ROI pharmacies rarely deviate from the recommended retail price (RRP) for non-prescription medicines.

6.23 This means that compared with the average ROI pharmacy, the average NI pharmacy is more likely; (a) to benefit from greater economies of scale and buyer power; (b) to supply cheaper own-brand products (not limited to medicines) and (c) to earn a smaller margin.

Supply Chain

Types of Operators

6.24 Pharmaceutical products are produced by a large number of manufacturers that are based all over the world including the ROI. Although retail pharmacies may and do obtain supplies of medicines directly from pharmaceutical manufacturers (about 10%[46]), retail pharmacies in the ROI tend to rely on pharmaceutical wholesalers for their supply of medicines, especially prescription medicines.[47] Pharmaceutical wholesalers purchase products from the manufacturers

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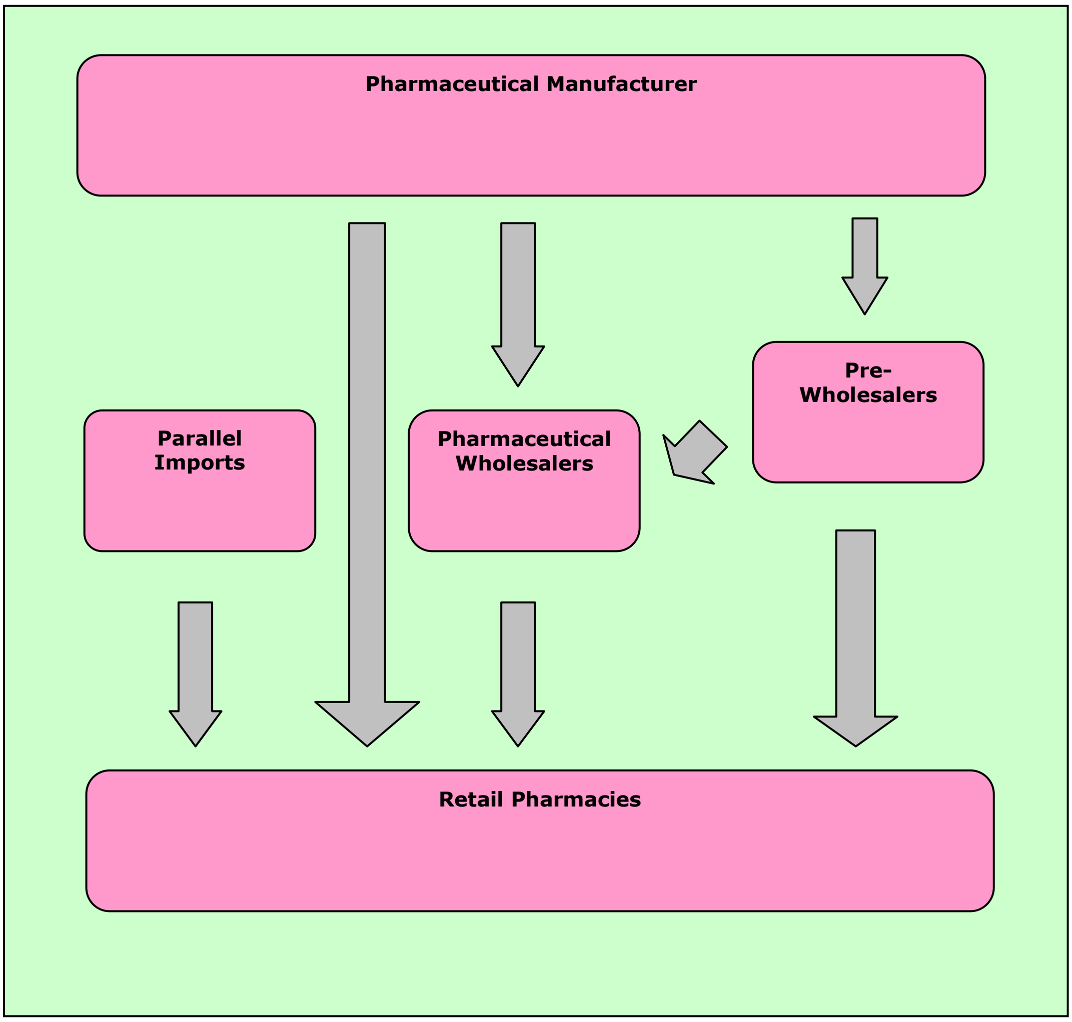
[44] Pharmacists could influence choice of medicine where a prescription is generically written or if the pharmacist refuses to prescribe a medicine because it may interact with other medication.
[45] Speech by Liz Hoctor, Irish Pharmacy Union (IPU), March 2007. Available from: http://www.ipu.ie/index.php?option=com_content&task=view&id=128&Itemid=221.
[46] This information was provided by a pharmaceutical wholesaler.
[47] Wholesalers would tend to deliver on a far more frequent basis.

(or their pre-wholesale agents[48]), store these products in anticipation of customer (pharmacy) demand, and then sell and deliver the desired quantities.

6.25 There are two different types of wholesaler: "full-line" and "short-line". Full-line wholesalers compete for the business of delivering prescription and other medicines and products on a very frequent basis (twice-daily). They focus on providing the full range of products available in small quantities at short notice. This is an especially valuable service to pharmacies for prescription medicines, and most retail pharmacy products are supplied through a full-line wholesaler. For the business of delivering products on a less frequent basis (e.g., common medicines that pharmacies sell a lot of, such as paracetamol), full-line wholesalers compete with short-line wholesalers and direct supply from manufacturers. Full-line wholesalers frequently operate a pre-wholesale business as well.

Figure 11: Pharmaceutical Products Supply Chain



6.26 Short-line wholesalers also supply pharmacies, but the service they provide can be clearly distinguished from that provided by full-line wholesalers, as the former generally concentrate on supplying a far

[48] Manufacturers sometimes employ a pre-wholesaler to distribute their products around the world. The pre-wholesaler usually acts as an agent for the manufacturer (i.e., they do not actually purchase the product and are paid based on what they sell); however in some cases they actually purchase the product, transport it and resell it to another wholesaler. The three largest wholesalers in the ROI also operate their own pre-wholesale businesses.

less comprehensive product range, and make deliveries only once or twice per week. Short-line wholesalers mostly supply fast-moving products, at greater discounts than those offered by full-line wholesalers. In terms of importance to the pharmacy, this service is secondary to that provided by full-line wholesalers.

6.27 In addition to full-line and short-line wholesalers, there are a number of very small parallel importers who purchase and import pharmaceutical products into the ROI. Parallel imports are becoming increasingly popular and now account for about 5-10%[49] of prescription medicine sales in the ROI.

6.28 A number of large retail pharmacy groups have the ability, if necessary, to commence wholesaling by means of purchasing groups. Indeed, Boots in the UK operates its own wholesaling division. However, given the importance that pharmacies attach to a quick and efficient delivery service, it is highly questionable how viable an alternative this would be to the service offered by the existing wholesalers in the ROI.

6.29 The wholesale sector has become increasingly concentrated over time through consolidation. This is consistent with general trends in other countries, particularly the US and the UK. Market shares of the wholesalers in the pharmaceutical market vary over time. However, three full-line firms are very significant in the market: United Drug, Uniphar and Cahill May Roberts (CMR).[50] Between them, these companies supply pharmacies in the ROI with approximately 85% of their total product.[51] The structure is similar to that in the UK, albeit on a much smaller scale. There is a significant amount of vertical integration between wholesale and retail pharmacy. For example, Uniphar operates the Life Pharmacy retail franchise, while it is in turn owned by community pharmacists. CMR is a subsidiary of Celesio, which owns the Unicare retail chain.

Regulation

6.30 Pharmaceutical wholesalers must obtain a licence from the IMB to wholesale prescription and non-prescription medicines to retailers. As mentioned earlier, the actual medicines sold must be approved by the IMB. This means that a wholesaler with an ROI licence cannot sell IMB approved products in NI and vice-versa. Parallel importers must get a specific parallel import licence from the IMB.

6.31 The prices to wholesalers of prescription medicines are set as part of the agreement between the State and the IPHA, which represent manufacturers of pharmaceutical products. The agreement covers all medicines prescribable and reimbursable under the GMS and other State Schemes, as well as all medicines supplied to hospitals and the HSE. The State previously fixed the wholesale margin at 15% and wholesalers were expected to compete for market share by range of products and frequency and responsiveness of their distribution service. This margin is deemed to be high and the State, through the HSE, has been seeking to lower it. Many non-prescription medicines are not covered by this agreement and can be priced freely. There is a

[49] Information provided by a pharmaceutical wholesaler.
[50] In 2004 the Competition Authority in its Uniphar merger determination M/04/020 (The proposed acquisition of Ammado by Uniphar plc), estimated that post-acquisition, United Drug would hold 40-45% of the market, Uniphar 30-35% and CMR 20-25%.
[51] Of the remaining 15%, short-line wholesalers supply about five per cent with direct supply from the manufacturer making up the remaining 10%.

similar regulatory structure in place in the UK (including NI); however, the wholesale margin is set at a lower rate of 12.5% for prescription drugs.

Nature of Competition

6.32 At the wholesale level, first impressions would be that price competition would be non-existent for prescription drugs, and that competition is confined to frequency of delivery and other terms as to quality. However, the discounts offered by wholesalers to pharmacies are significant and this amounts to substantial price competition. The discount offered will depend on the volume of turnover and location of a pharmacy, as well as whether it is part of a chain and how quickly it settles its bills.

6.33 However, pharmacies may require a significant change in discount terms to consider switching suppliers. Pharmacies often emphasise the importance of loyalty to a wholesaler; by switching wholesalers regularly, pharmacies risk damaging relations that may affect the quality of the delivery service received from the wholesaler.[52]

6.34 There is some, albeit limited, competition from short-line suppliers, pre-wholesalers and from the manufacturer itself. However, competition from parallel importers is growing.[53] Parallel importers buy prescription medicines mainly in the UK, import them into the ROI and many re-label and/or re-leaflet them before they sell them to pharmacies at competitive prices.

Manufacturing Level

6.35 As stated earlier, wholesalers and some retail pharmacies obtain a portion of their medicine supplies (about 10%) directly from pharmaceutical manufacturers. Many of these products are produced overseas although there is also a significant pharmaceutical manufacturing base in the ROI (e.g., GSK, Abbott, Pfizer, and Wyeth). In light of the Government-industry pricing and reimbursement agreement, an ROI wholesaler must pay the "Irish price" for prescription medicines. Through negotiation a wholesaler might receive some bonus non-prescription product, but the manufacturers cannot deviate from the ROI price set for the prescription medicine.

6.36 For non-prescription medicines the manufacturer will set the price according to the market into which they are selling. ROI pharmacy and wholesaler buying power is considerably less compared to the UK and the wholesaler is less likely to benefit from discounts.

Supplier Price Differentials

6.37 The lack of comparable pharmaceutical price data means that the full extent of the price differentials for pharmaceutical products between the ROI and the UK (incl. NI) is not known.

6.38 The prices of prescription medicines in both the ROI and the UK entirely reflect Government policy. The systems used by the State to reimburse pharmacies in both jurisdictions are different and difficult to

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[52] Competition Authority (2004), Uniphar Merger Decision (The proposed acquisition of Ammado by Uniphar plc), [M/04/020].

[53] An ROI pharmaceutical wholesaler has indicated that parallel imports now account for approximately 5-10% of prescription medicine sales in the ROI.

compare. However, the wholesale margin for prescription medicines in the ROI is currently 15% compared to 12.5% in the UK, while cheaper generic prescription medicines are more commonly used in the UK. Furthermore, the mark-up on private prescriptions in the ROI at 50% is regarded as being one of the highest in the EU.

6.39 Anecdotal evidence is that non-prescription pharmaceutical retail product prices in the ROI may have been higher than those in the UK. Any price difference that has emerged might be explained by the following features of the retail pharmacy market in the ROI:

- A smaller population and fewer large retail chains means that buying power for retailers and wholesalers is considerably less when dealing directly with manufacturers compared to the UK. Moreover, licensing regulation makes it extremely difficult for retail chains to import medicines from cheaper jurisdictions;
- The relative lack of large retail chains also means that (a) pharmacies are less likely to benefit from greater economies of scale and (b) pharmacies are less likely to stock a range of cheaper own-brand non-prescription products, with the result that prices are likely to be higher compared to the UK. This point does not apply to the largest retail pharmacy chains in the ROI who have suggested that they charge lower prices for non-prescription medicines compared to independent pharmacies;
- It was suggested to the Competition Authority that, in comparison to the UK, independent ROI pharmacies rarely deviate from the recommended retail price (RRP) for non-prescription medicines;and
- Retail pharmacy chains and wholesalers that operate in both jurisdictions have indicated that the operating costs in the ROI are higher than those in NI. Property costs, energy costs and the cost of hiring a pharmacist are frequently highlighted as being particularly high in the ROI.

Impact of STG Depreciation and Reaction of Retailers and Suppliers

6.40 Retailers and wholesalers of pharmaceutical products in the ROI have indicated that sales of prescription medicines have levelled out in recent months, sales of non-prescription medicines have decreased slightly and sales of CTS products have fallen sharply. The industry view is that falling sales have little to do with STG depreciation; rather consumers are now buying fewer pharmaceutical products because of the recession.

6.41 The impact of the depreciation of STG is minimal because prescription medicine prices are set by the State and retailers and wholesalers are restricted from going outside the ROI for supplies of pharmaceutical products for important regulatory reasons. Just like a prescription issued in the ROI cannot be used in NI and vice-versa, ROI pharmacies and wholesalers cannot purchase medicines in NI and import them across the border unless they are licensed to do so.

6.42 Pharmacy retailers have indicated that they are responding to falling sales by lowering non-prescription prices where possible and placing greater pressure on wholesalers and manufacturers to provide them with greater discounts. This in turn has led to wholesalers demanding greater discounts from manufacturers.

6.43 The STG depreciation has had some impact in the area of parallel imports of prescription drugs. The strength of the EURO versus STG has given parallel importers a greater incentive to import medicines into the ROI and sell them to pharmacies at competitive prices. However, parallel importers must get a licence to operate and acquire a separate IMB licence for every medicine they wish to import, even if the drug already has a licence in the ROI.[54] This can often be an expensive and/or time consuming process. However, the demand for cheaper parallel imports has been growing and they now account for about 5-10% of prescription medicine sales in the ROI.

Concluding Comment

6.44 The State's primary concern in this sector is, and should be, the delivery of health services across the country. The licensing restrictions, for example, are a proportionate response to ensuring ethical practice.

6.45 However, the State also has the aim of ensuring that healthcare delivery is efficient and cost-effective. The 50% mark-up paid to pharmacies for medicines dispensed under the DPS and LTI schemes is among the highest in the EU. While pharmacies, like all retailers in the ROI, face higher costs of doing business here, a 50% mark-up is not justifiable. This is especially true when one considers the substantial discounts pharmacies receive from wholesalers. It is perhaps not surprising that the ROI has so many pharmacies compared to its small population.

6.46 A side-effect of the 50% mark-up is that pharmacies whose customers are mainly medical card holders earn a lot less than other pharmacies (as no mark-up is paid). In addition, it is not clear why the State should reimburse pharmacies on a percentage basis at all. Apart from certain hi-tech or special storage medicines, dispensing a medicine and providing advice is not directly related to the cost of the medicine.

6.47 The recent strengthening of the EURO versus STG has changed the price differential on retail pharmaceuticals. However, retailers and wholesalers are restricted from going outside the ROI for supplies of pharmaceuticals for important regulatory reasons. While the STG depreciation would appear to have increased the demand for cheaper parallel imports, its impact on the price and sales of pharmaceutical products is small.

6.48 The recession has had a far greater impact on pharmaceutical sales than the STG depreciation. Retailers and wholesalers have indicated that sales of prescription medicines have levelled out while sales of non-prescription medicines have fallen slightly because of the recession. Sales of CTS products have fallen sharply. While large retail chains like Boots can easily obtain these products in sterling from their UK wholesaler and are passing on savings to consumers, other pharmacies and wholesalers are seeking better value from suppliers, just like grocery retailers as outlined earlier in this Report.

[54] The IMB might request that some ingredient, labelling or packaging needs to be changed in someway in order to be granted a licence for the ROI.

7. CONCLUSION

Background and Context

7.1 The Tánaiste's request to carry out a study of the retail-related import/distribution sector was made in the context of a widening price differential between retail goods in the ROI and NI as sterling weakens against the EURO, and the recent Forfás report which suggested that "*the fact that the strong euro does not appear to be translating into lower import costs may be indicative of a lack of competition in the import, distribution and retail sectors*".[55]

7.2 While the focus of the Report is on the supply of imported goods for retail in Ireland, it is important to keep in mind that prices are always determined by both demand and supply conditions. Pricing decisions, by retailers and manufacturers, are made in the context of what consumers are prepared to pay.

7.3 Relative price levels in the ROI vis-à-vis NI, and the sterling zone more generally, are likely to differ as pricing decisions are made in two different economies with two different and fluctuating currencies. This Report thus sought to answer two questions:

i. What differences in the retail and supply landscape of the ROI and NI can contribute to prices differences?; and,

ii. Are there problems in the supply chain preventing ROI prices and NI prices from converging?

7.4 It would not be possible to answer these questions in detail for every consumer product retailed in Ireland. The Report thus focuses on three important retail sectors: groceries, clothing and pharmaceutical medicines. For each of these retail sectors the Report describes the associated supply chain (in particular, for imported goods) and how competition works throughout that chain.

What Factors Cause Prices to be Different Across Borders?

7.5 A number of factors can contribute to retail price differences between the ROI and NI. They include:

- **Consumer demand:** Consumer tastes and the level of disposable income that households have affect the price that they are willing to pay for goods and services. Exporters frequently "price-to-market", that is, they will set their mark-up in each country according to the demand conditions they face. Disposable income, one of the most important determinants of consumer demand, is affected by wages, taxes and access to credit. Disposable incomes in the ROI have been higher than in NI for some time. Consumer tastes also differ somewhat between the ROI and NI.
- **Different tax regimes**: Different VAT, excise and duty rates are applied in the ROI and NI/UK.
- **Cost of doing business:** Differences in wages, land prices, rent, energy prices, transport costs, waste collection costs, cost of legal and other professional services, etc., combine to create different cost bases in the ROI and NI. Currently the ROI cost base is

[55] "The Cost of Running Retail Operations in Ireland", Forfás, December 2008 available at http://www.forfas.ie/publication/search.jsp?ft=/publications/2008/Title,2623,en.php

significantly higher, especially when Dublin is compared with Belfast.

- **Different levels of competition:** Differences in the levels of competition will tend to lead to different price levels. For example, grocery retailing in the ROI is in general more concentrated (i.e., fewer retailers account for a greater share of turnover) than in the UK. Moreover, there is a different mix of retailers and competition operates differently at the local level. In contrast to the ROI grocery sector, the clothing sector in ROI is much less concentrated and there has been a substantial expansion in the number of brands available over the past decade.
- **Different regulations:** For example, the price of pharmaceuticals to retail pharmacists in the ROI and in NI are regulated by the Irish and British governments respectively. Regulations on entry into the grocery market in Ireland are restricted by the operation of the planning system.[56]

7.6 All of these factors affect the pricing options and decisions of both retailers and their suppliers.

Are Prices in ROI and NI Converging?

7.7 There have been two substantial depreciations in the value of STG against the EURO over the past year. This recent volatility contrasts sharply with the preceding period of enduring stability. The fall in the relative value of STG raises the possibility that goods manufactured in the STG zone might now be purchased for less EURO. In other words, import prices from the STG zone should now be falling and therefore feeding through into lower retail prices.

7.8 So called exchange rate pass-through is, however, never complete or immediate. Many explanations as why this may be the case have been put forward. On one extreme are assertions that retailers or suppliers are hoarding savings made from exchange rate movements and that such savings are simply absorbed into their margins. Whether it is the retailer or the supplier who absorbs a greater share of available exchange rate savings likely depends on the relative bargaining strengths of the parties, and the manner in which product is invoiced. Clearly, the level of competition faced by retailers is also relevant to the extent to which savings may be withheld from consumers.

7.9 At the other extreme are assertions that even though certain goods are imported from the STG zone, only a very small proportion of costs arise within the STG zone and that therefore, very little savings arising from exchange rate movements are actually even potentially available.

7.10 Between these extremes are explanations that focus on rigidities that tend to slow the process of pass-through. For example, exchange rate risk management (i.e., hedging) and supply chain inflexibilities tend to slow the process of pass-through. Hedging explanations tend to centre on the notion that by managing exchange rate risk, no actual benefits (or costs) arise from exchange rate movements in the short run and that any pass-through if it occurs, will only occur in the medium to longer term. Supply chain inflexibilities refer to the ease with which retailers and other operators along the supply chain can take advantage of alternative and better value supply options. The greater

[56] See The Competition Authority's "*Grocery Monitor Report No. 3 - The Retail Planning System as Applied to the Grocery Sector: 2001 to 2007*".

the ease with which sources of suitable alternative supplies may be accessed, the faster pass-through will be.

7.11 Each of these and other factors plays a part in the overall explanation of exchange rate pass-through and is to a significant extent dependent on the peculiarities of different sectors and products.

Groceries

7.12 In the grocery sector, retailers are facing declining demand due to both the effects of the recession and the diversion of shoppers to NI. Consequently, these retailers are looking at ways to drive sales and to protect their margins – they are thus looking at all their costs, including going to their suppliers for better prices.

7.13 Suppliers monitor differences in the prices of their products to retailers in the UK (and particularly in NI) and the prices of their products to retailers in ROI. Many suppliers and retailers spoke of a "price corridor", in relation to supplier prices, that is monitored to ensure it does not become so wide as to destabilise the supply chain.

7.14 It is clear that the grocery market in ROI has undergone significant changes in response to the retail price differential generally between NI and ROI. Most notably, these changes include:

- Tesco moving to direct supply from the UK for many grocery products;
- Lidl and Aldi continue to grow rapidly and are largely unaffected on the supply side as very little of their product is sourced within the STG zone;
- Other retailers and wholesalers are actively buying from NI wholesalers and UK buying groups;
- UK wholesalers with full distribution capabilities have entered the ROI market;
- Parallel importing into ROI has become more common place; and,
- ROI consumers continue to travel to NI in search of lower prices.

7.15 These factors are placing significant pressure on Irish distributors and Irish offices of international brands.

7.16 Suppliers of groceries have generally reacted by (a) reducing prices, (b) offering more promotions, or (c) a combination of both. Those suppliers that have manufacturing bases in the UK generally have benefited more from the depreciation of STG and therefore are in a better position to pass on those benefits as direct price cuts (at least to the extent that a substantial portion of their costs arise within the STG zone). This is consistent with the economic research which finds that currency change pass-through depends on how much of the cost base is actually in that currency. Deeper promotions are preferred by suppliers as they ensure the price drop goes fully to the consumer (as opposed to some being kept back by the retailer) and they are a temporary response to what is generally considered a temporary currency situation. Suppliers do not want to have to renegotiate a price increase in the ROI if STG appreciates/strengthens against the EURO again.

7.17 The evidence suggests that the grocery supply chain is responding to the changed economic environment. The fact that the response is not complete or immediate is due in part to the fact that little manufacturing in actually done in the UK and that raw materials are priced in EUROs and dollars, and in part to the normal negotiation process between retailers and suppliers. At the same time, food and non-alcoholic beverage prices are now rising faster in the UK than in the ROI.

Clothing

7.18 In the clothing sector, as in the grocery sector, retailers are facing declining demand due to both to the effects of the recession and the depreciation of STG. Consumers are buying less clothes, switching to NI stores or on-line sales from the UK, and also switching to the low cost chains, e.g., to Penneys.

7.19 Clothing price differences between NI and the ROI have significantly changed and in fact reversed in recent years. In 2007 the ROI average price of clothing was lower than that in the UK; now, as evidenced by surveys and the diversion of shoppers to NI, purchasing clothing in ROI is significantly more expensive. This effect is especially noticeable in clothing retailing due to retailer "dual ticketing", i.e., the practice of labelling clothing with both the EURO and STG prices.

7.20 Retailers have indicated that they are looking at ways to drive sales and to protect their margins.

- Clothing retailers have been looking to reduce all their costs, including the prices they pay to suppliers, as well as operating costs – e.g., a number of clothing retailers have reduced opening hours; and,
- Clothing retailers have sought to stimulate demand through increased sales and promotion activity – clothing and footwear prices fell much faster in the ROI than in the UK in January 2009.

7.21 Most notable, however, is the apparent low level of parallel imports into Ireland. A large number of clothing retailers are vertically-integrated international brands and so have tightly controlled distribution systems that are run by their parent company. Other retailers, e.g., independent retailers and department stores, while being successful to some degree in sourcing in STG, contend they are not able to by-pass their suppliers. Competition in clothing is largely about branding and image, within a particular price/quality range. Thus, it is difficult for stores with ongoing relationships with brands to switch to alternative brands or to the grey market, where the goods cannot be relied on to come in the full range of sizes or colours or even to be from the current season.

7.22 Clothing is a highly seasonal product. The prices currently appearing in ROI stores were set six to twelve months ago and renegotiating those prices is difficult and dependent on a retailer's buying power. Retailers have indicated that they have had some success in renegotiating lower prices but not a lot. ROI stores that have access to stock through related UK stores have slightly more scope to access products at STG prices.

7.23 As the seasons continue, suppliers have the opportunity to set ROI and NI prices in a way that reflects more recent exchange rates.

Pharmaceutical Products

7.24 The prices of the vast majority of medicines in the ROI and the UK (and thus NI) are set by each State and entirely reflect government policy. Approximately 80% of the value of all medicine sales in the ROI are recouped from the State, making it the single largest buyer of pharmaceutical products in the ROI.

7.25 As part of the tight controls on the sale of medicines in ROI, every medicine sold in Ireland requires a licence from the Irish Medicines Board, which dictates the medicine strength per tablet, pack size allowed and information to be provided. Furthermore, retailers and wholesalers are legally restricted from going outside the ROI for supplies of pharmaceuticals, with the exception of a very small number of specially licensed parallel importers who typically have less than 5% of the ROI wholesale market.

7.26 The impact of the STG depreciation has thus been negligible in terms of reducing sales or lowering prices of medicines in ROI. Its main impact has been in the area of parallel imports of prescription drugs. The strength of the EURO versus STG has given licensed parallel importers a greater incentive to import medicines into the ROI and sell them to pharmacies at competitive prices.

7.27 The recession has had some impact on pharmaceutical sales. Retailers and wholesalers have indicated that sales of prescription medicines have levelled out while sales of non-prescription medicines have fallen slightly because of the recession.

Final Comment

7.28 This Report was completed in the context of a widening price differential between retail goods in ROI and NI. To understand this price differential this Report has analysed factors contributing to price movements in the wider economies as well as the particular characteristics of the retail related import and distribution sectors.

7.29 There has been a divergence of currency values between STG and the EURO - in March 2007, €1 was worth £0.68; by March 2008, €1 was worth £0.92 - as well as a divergence of inflation rates - between 2000 and 2008 Eurozone inflation rates were consistently higher than UK inflation rates. This records the widening of the price differential between 2000 and 2008.

7.30 More recent figures indicate a part reversal of this trend - prices in the UK have been rising at a faster rate since mid-2008.

7.31 Short and medium term price differentials are to be expected in neighboring economies. Currency pass-through in such markets is never 100% - particularly in the short term. That is, it is typically the case that prices in both the ROI and UK take some time to adjust to a new equilibrium exchange rate.

7.32 In the retail sector, we see a number of different reactions to the price differential. Consumers are travelling and will continue to travel to NI as long as the retail price differential remains substantial. This in turn will have an effect on the import and distribution sectors as ROI retailers take steps to reduce their costs to maintain their competitiveness.

7.33 However, the effectiveness and timeliness of actions that can be taken by retailers in relation to their cost of goods from suppliers varies from market to market and may be different depending on products within a market. In the grocery market we have seen significant changes in distribution practices as retailers use a variety of strategies to either change suppliers or to negotiate better terms from existing suppliers. In pharmaceutical markets and certain segments of the clothing market we have seen less changes in distribution arrangements and this is due to either the regulatory framework (in the case of pharmaceuticals) or the unique nature of the product (in the case of certain branded clothing). Accordingly, where distributions arrangements are less flexible, price differentials in the cost of goods are sustainable for a longer period.

7.34 The significant factors that sustain a retail price differential between ROI and NI are a mix of external factors (currency movements) and internal factors (tax, cost of doing business, state of competition and regulation). As the external factors remain outside our control, the focus on policy going forward should be on the internal factors. The Competition Authority has written extensively on reducing the costs of doing business and removing restrictions on competition in the retail sector and implementation of our recommendations in our reports sets out a roadmap for such reform. Finally, private agreements or practices that may be restricting or distorting competition is appropriately dealt with by enforcement action and such enforcement action is outside the scope of this report.

A. THE MINISTER'S REQUEST

Mr William Prasifka
Chairman
The Competition Authority
14 Parnell Square
Dublin 1

Dear Bill,

Last year I asked Forfás to examine the comparative costs of running retail operations in a number of cities in Ireland, the UK and the Netherlands. The Report was published in December 2008 and is available on www.foras.ie/publications/2008.

Key findings included:

- The wholesale cost of goods for sale in stores was by far the biggest cost faced by retailers and accounted for 75 to 80 per cent of their total costs.
- Operating costs, principally labour, property and utilities, accounted for 20 to 25 per cent of retailers' total costs.
- Operating costs in Dublin were higher than in all of the other locations surveyed except London and were 25 per cent higher on average than in Belfast. The cost base in Cork, Limerick and Galway was more competitive with locations in the UK.
- Higher operating costs in Dublin or other locations in Ireland affect only the 20 to 25 per cent of retailers' total costs accounted for by operating costs. The 25 per cent operating cost differential between Dublin and Belfast therefore would add 5 to 6 per cent to the overall cost base of a retail business in Dublin compared with a similar business in Belfast.
- Though higher operating costs in the South add no more than 5 to 6 per cent to the total cost base of a retail operation here compared with one in Northern Ireland, the available evidence suggests that the gap between prices North and South is substantially higher.

Concluding that the "fact that the strong euro does not appear to be translating into lower import costs may be indicative of a lack of competition in the import, distribution and retail sectors" Forfás recommended that a review of competition in the retail related import/distribution sector should be undertaken. Such a review should assess whether the lack of competition is inhibiting the benefits of sterling weaknesses being passed on in lower prices to consumer. In addition to Forfás' recommendation, you will also be aware of the recent communication from the European Commission calling on national competition and consumer protection authorities to monitor potential unfair commercial practices in the food sector which may be holding back competition and consumer protection.

You are no doubt aware of the controversy surrounding this issue and the euro/sterling differential which have featured strongly during the course of my engagement with retailers.

The Government remains fully committed to improving the cost competitiveness of the business environment. In accordance with section 30 (2) of the Competition Act 2002, I am requesting the Competition Authority to carry out a study/analysis of the retail related import/distribution sector. The study should examine how that sector operates, how competition works in the sector and whether any practice or method of competition affects the supply and distribution of goods within that sector. I would also like the Authority to consider the impact on competition within the sector of direct importation from source countries, rather than indirectly through the UK.

I would appreciate receiving this Report by 30th April 2009.

Yours sincerely

Mary Coughlan TD

Tánaiste and Minister for Enterprise, Trade & Employment

B. NARROWING THE SCOPE OF THE REPORT

Introduction

B.1 The purpose of this Chapter is to facilitate narrowing the scope of the Report. First, the breadth of the consumer retail sector is presented. This shows that the potential number of consumer retail sectors is very broad and that the focus of the Report needed to be narrowed if it is to be of value, given the short time frame for completion.

B.2 Second, an initial set of criteria is applied to create a shortlist of potential sectors for detailed analysis. These criteria are based on the level of prior knowledge within the Competition Authority relating to different consumer retail sectors and also on the level of public interest.

B.3 Finally, a second set of criteria is applied to the shortlisted sectors. These criteria are designed to ensure that the Report focuses on areas where consumers spend most and, moreover, have little discretion.

The Breadth of Consumer Retail Sectors

B.4 The Tánaiste requested that the Competition Authority study the "retail related import/distribution sector"; the horizontal scope of this request covers all retail sectors. The Competition Authority interprets the retail sector to be the sale and purchase of consumer goods.

B.5 An appropriate starting point in assessing the breadth of consumer retail sectors and their importance to consumers is the Consumer Price Index ("CPI"). The CPI is an index that measures changes in the average price of goods and services consumed by households. The index covers over 1,000 different varieties of goods and services.

B.6 The CPI is a weighted average index. This means that expenditure weights are used in the index to reflect the proportion of expenditure by households on various categories of goods and services. Expenditure on capital assets and investments, gambling and certain other activities are, however, excluded. In effect, the weighting of each item in the basket is a way of expressing the importance of each category of goods.

B.7 The consumer basket can be split into two parts – goods and services. Together, all goods account for, or have a weight of, 47.08% in the CPI, i.e., consumers spend on average 47% of their expenditure on goods; while services account for the remaining 52.92%. For the purposes of this Report services are discounted from the analysis. Table B.1 details the CPI goods categories and sub-categories as well as their corresponding expenditure weights. Table B.1 indicates the breadth of potential consumer retail sectors that could be analysed.

Criteria for Narrowing Scope

B.8 A comprehensive analysis of the supply chain, including import/distribution elements, behind every consumer retail sector is clearly not feasible within the timeframe of this Report. To focus efforts on sectors that would maximise the value of the Report, it is necessary to narrow its scope. To achieve this, the Competition Authority developed criteria to progressively narrow the scope of the Report. A two-stage approach was adopted.

Table B.1: CPI Categories and Expenditure Weights (Goods Only)

CPI Category	Dec 2006 Expenditure Weight
Food and Non -Alcoholic Beverages	**11.74**
Food	10.81
Non-alcoholic beverages	0.93
Alcoholic Beverages and Tobacco	**6.05**
Alcoholic Beverages	2.87
Tobacco	3.18
Clothing and Footwear	**5.26**
Garments and other articles of Clothing	4.3
Footwear	0.9
Housing, Water, Electricity, Gas and Other Fuels	**3.2**
Materials for maintenance and repair of dwelling	1.51
Bottled gas and other fuels	1.71
Furnishings, Household Equipments and Routine Household Maintenance	**3.56**
Furniture, furnishings, carpets and other flooring	1.08
Household textiles	0.24
Household appliances	0.97
Glassware, Tableware and Household utensils	0.26
Tools and equipment for house and garden	0.36
Non- durable household goods	0.67
Health	**1.18**
Medical Products, appliances and equipment (including Pharmaceutical Products)	1.18 (0.87)
Transport	**9.83**
Purchase of Vehicles	5.73
Spare parts and accessories	0.34
Fuels and lubricants	3.75
Communications	**0.018**
Telephone and Telefax Equipment	0.018
Recreation and Culture	**4.23**
Audio-visual, photographic and info processing equipment	1.05
Other major durables for recreation and culture (musical instruments)	0.01
Other recreational items & equip. incl. gardens and pets	1.44
Newspapers, books and stationary	1.73
Miscellaneous Goods and Services	**2**
Personal care	1.52
Personal goods	0.49

Source: Consumer Price Index

B.9 The first stage involved applying the following two criteria:

- Level of existing knowledge within the Competition Authority; and,
- Level of public interest/focus of public debate.

B.10 The application of these criteria to the breadth of potential consumer retail sectors allowed the Competition Authority to shortlist eight consumer product categories. The second set of selection criteria was then applied. The second stage criteria are:

- The magnitude of consumer spend on the product category; and,
- The discretionary nature of the product category; i.e., the degree to which the product category is considered a necessity.

B.11 The choice of these two additional criteria allowed the Competition Authority to focus on consumer products on which consumers spend most and, which, to a significant extent, they cannot avoid purchasing. The application of these additional criteria allowed the Competition Authority to focus on three areas which are considered in much greater detail in Chapters 6, 7 and 8.

Narrowing the Scope: Stage 1

B.12 The first stage involves applying the following two criteria:

- Level of existing knowledge within the Competition Authority; and,
- Level of public interest/focus of public debate.

Level of Existing In-house Knowledge

B.13 Due to the short timeframe for the completion of this Report it is necessary, in as far as possible, to build on existing in-house knowledge. From an internal assessment across the Competition Authority, the principal sectors from the CPI headings for which there is existing in-house knowledge are:

- Groceries: The Competition Authority published, in 2008, three *Grocery Monitor* Reports. Groceries include four categories from the CPI: food, non-alcoholic beverages, non-durable household goods and personal care;
- Alcoholic beverages: The Competition Authority has knowledge of the off-trade sale and distribution of alcoholic beverages from merger assessments;
- Fuels and Lubricants: The Competition Authority is aware of the structure and nature of agreements in this sector due to its Solus Agreement Declaration. In 1993 the Competition Authority granted a Category License to exclusive purchase agreements of less than 10 years for the resale of petroleum products in service stations. These agreements are known as solus agreements. This Category License expired on 30th June 2008, and was replaced by a Category Declaration, which itself will expire on 30th June 2010;
- Pharmaceuticals: The Competition Authority has knowledge of this area due to the European Commission's inquiry into the pharmaceutical sector, the Competition Authority's work on the regulation of the sector, and the public debates on the fixing of prices by Government for the products it purchases on behalf of patients on the various drug schemes in the State;

- Motor Vehicles: The Competition Authority is aware of the rules governing the distribution and servicing of new motor vehicles due to the European Commission's Motor Vehicle Block Exemption Regulation; and,
- Newspapers and Periodicals: All media mergers must be notified to the Competition Authority; therefore the Competition Authority has developed a substantial amount of knowledge in this area.

Level of Public Interest/Debate

B.14 There has been a significant amount of public debate on certain retail sectors. The price differential between the ROI and NI for groceries, clothing, and electrical goods has been highlighted in surveys by the NCA. Issues arising from these surveys, the Forfás Report and Oireachtas debates were the principal reason for the initiation of this Report. In undertaking this Report, the Competition Authority published a notice calling for submissions from interested parties and the general public. Table B.2 details the number of submissions received and is categorised by the retail sector to which the submission referred. It should be noted that only two submissions were from the general public and that the majority of submissions were received from retailers. The vast majority of submissions received related to food retail in comparison to other retail sectors.

Table B.2: Submissions by Retail Businesses

Retail Business Referred to:	Number of Submissions
Grocery Businesses	108
General Retail	7
Department Store	1
Hardware and Building	1
IT products	1
Flooring	1

B.15 This first stage of narrowing the scope of the Report suggested that the following eight categories could be given further consideration:

i. Groceries;

ii. Clothing;

iii. Alcoholic beverages;

iv. Household appliances;

v. Pharmaceutical products;

vi. Motor vehicles;

vii. Fuel and lubricants; and,

viii. Newspapers and periodicals.

B.16 These categories cover the majority of the CPI goods base. The combined expenditure weight attributed to these in categories the CPI is 34.15%, or approximately 73% of the goods base (i.e., having already excluded services).

Narrowing the Scope: Stage 2

B.17 The second stage criteria are:

- The magnitude of consumer spend on the product category; and,
- The discretionary nature of the product category.

Table B.3: The Shortlisted Retail Categories Ranked by Expenditure Weight

CPI Sub-Category	Expenditure Weight
Grocery	13.93
Purchase of Vehicles	5.73
Garments & Other Articles of Clothing	4.3
Fuels & lubricants	3.75
Alcoholic Beverages	2.87
Newspapers, books & stationary	1.73
Household Appliances	0.97
Pharmaceutical products	0.87

Source: Consumer Price Index

Magnitude of Consumer Spend

B.18 In order to be relevant it is necessary to choose sectors that are of importance to consumers. This involves choosing sectors characterised by significant consumer expenditure. Table B.3 details the sectors of most importance to consumers by ranking, in terms of expenditure weight, the eight shortlisted retail categories previously mentioned.

Discretionary Nature of Product Category

B.19 It is also important that sectors which sell necessities are selected, i.e., sectors in which, even during times of recession, demand is relatively constant. The CSO Retail Sales Index ("RSI") provides a monthly indicator of economic activity in Ireland. The RSI measures retail trading and provides a valuable guide to consumer spending behaviour in the ROI retail market. The RSI defines retail trade as that of division 52 of the NACE Code, which defines retail trade as "*the resale of new and used goods to the general public for personal or household consumption or utilisation, by shops, department stores, stalls, mail-order houses, hawkers and peddlers, consumer co-operatives etc.*".[1]

[1] For pragmatic reasons the RSI defines retail trade as NACE Rev.1 Division 52 (excluding classes 52.48 – 52.74). In other words, the RSI excludes sales by hawkers, street stalls and markets, street based newspaper vendors and other retailing activities not conducted from permanent business premises. In addition, the following are excluded: mail-order, second hand and repairs of personal, electrical and household goods unless included as turnover arising from a secondary activity but classified to the principal activity. The direct retail sales of non-distribution enterprises

B.20 For the retail categories shortlisted, Table B.4 lists, in ascending order, retail businesses in terms of the change in volume of sales for the year to December 2008. Thus food, as represented by the retail business groups "food, beverages and tobacco" and "non-specialised stores", has seen the smallest volume change in sales; these include specialised stores such as butchers and standalone off-licences, and non-specialised stores such as major supermarket multiple chains respectively. This indicates that these categories are a necessity for consumers. At the other end of the spectrum, electrical goods have experienced the largest decrease in sales; this indicates that they are not being upgraded or replaced.

Table B.4: Annual Percentage Change in Volume of Sales of Retail Businesses (December 2008)

Retail Business	**Volume of Sales Annual % Change (Dec 08)**
Food, Beverages and Tobacco	-3.5
Non-specialised Stores[1]	-3.6
Pharmaceutical, Medical & Cosmetic Articles	-3.7
Textiles and Clothing	-5.7
Department Stores	-9.9
Books, Newspapers and Stationary	-14.3
Motor Trade	-15.3
Electrical Goods	-23.4

1. Non-specialised stores include the major multiple supermarket chains

Source: Retails Sales Index, March 2009

B.21 These indices indicate that food and pharmaceutical, medical and cosmetic articles are the most important sectors to consumers. Food has the highest expenditure weight in the CPI and has had the smallest fluctuation in demand in the RSI. Clothing ("garments and other articles of clothing") has the third highest expenditure weight and in the RSI "textiles and clothing" and "department stores" are ranked fourth and fifth respectively.

Conclusion

B.22 Based on the above criteria the Competition Authority chose to analyse in more detail three retail sectors:

- Groceries: Groceries includes food, non-alcoholic beverages, non-durable household goods and personal care. Tobacco and alcoholic

(e.g. manufacturing enterprises with no separate sales establishments) together with the incidental sales of wholesale businesses are also excluded. In addition, the RSI is different to the NACE code as it includes elements of other divisions – Sale, maintenance and repair of motor vehicles, motorcycles and automotive fuel) and Groups (NACE 55.4 – Bars) have been added. Central Statistics Office, *The Irish Retail Sales Index: A brief introduction.*

beverages will not be included in the subsequent analysis of this sector;

- Clothing: Clothing includes men's and ladies' clothing, children's clothing, swimwear, socks and so on; it does not include footwear or clothing accessories; and
- Pharmaceutical products: This includes prescribed drugs and over the counter medication, e.g., antacids, cough mixture, vitamins and other supplements.

B.23 Despite trying economic circumstances consumers have little discretion over the three categories chosen; they are considered necessities as indicated by the fact that the volume of sales for these categories has remained relatively constant. For categories that have a large expenditure weight, such as the purchase of vehicles, the discretionary nature of these categories, as indicated by substantial fluctuations in the RSI, shows that consumers do not consider these products to be as necessary as other categories.

B.24 In addition, there has been a significant amount of public debate on and interest in the three categories chosen. Surveys have shown that a substantial price differential exists between the ROI and NI with respect to groceries and clothing due to the depreciation of STG. With respect to pharmaceuticals there is a continuous debate on prices. While other categories have attracted public debate, such as the price of fuel and electrical products, the latter, as shown in the RSI, are not considered necessities for consumers and issues surrounding the former do not relate to a price differential or the depreciation of STG.[2]

B.25 Newspapers, books and periodicals, and alcoholic beverages were not raised as a priority in submissions or via the application of the criteria, nor has there been a public debate in relation to newspapers, books and periodicals. While there is often public debate on alcoholic beverages, this tends to refer to Government policy on taxation and health issues. In conclusion, given the timeframe for the Report, and the criteria applied, it is the Competition Authority's view that further analysis of groceries, clothing and pharmaceutical products maximises the value of the Report.

[2] The NCA has examined the pricing of liquid fuels. The Report is available at: http://www.nca.ie/eng/Research_Zone/Reports/NCA_petrol_and_diesel_price_investigation.doc

C. SUMMARY OF SUBMISSIONS RECEIVED

C.1 On 28th February 2009, the Competition Authority published the terms of reference of the retail-related import/distribution sector Report and invited interested parties and the general public to make submissions. The invitation was issued via national newspapers and the Competition Authority's website. The Competition Authority received a total of 119 submissions.

Table C.1: Breakdown of Submissions

Source		Number
Retailer (Total)		**106**
	Franchisee Grocery Retailer	*102*
	Grocery Retailer / Franchisor	*3*
	Department Store	*1*
Supplier (Total)		**3**
	Importer/Distributor	*2*
	Producer	*1*
Representative Body		**6**
Member of General Public		2
Public Agency		1
Academic Research Institution		1
Total		**119**

C.2 The key issues raised in the submissions can be summarised according to the following four categories:

i. Supplier practices;

ii. Retailer practices;

iii. Cost (Cost of product and Cost of doing business);and

iv. Other issues.

Supplier Issues

C.3 A number of submissions offered mixed opinions and information on the supply level. Some submissions indicate that there are no major barriers for importation and distribution in their sectors. However, in other sectors, some submissions indicate that it is difficult to establish a chain of distribution from origin countries directly, i.e., without help of a wholesaler/importation partner in the ROI. It seems, for those sectors, there is an extra layer in the supply chain for many international companies' products compared to UK (including NI). In such cases, the logistical obstacle to direct importation of products is a very significant issue. This means it is not possible in all cases to by-pass existing distribution structures and purchase directly from major international brand owners.

C.4 Some submissions raised the issue of the lag in the price changes for products imported from the UK. Despite the fact that EURO/STG exchange rate has changed, only a small number of suppliers have been in the position to pass on exchange rate related savings. One of the reasons given for being unable to give currency discounts is that suppliers seem to have booked currency at the old rates for a significant period, thus they are unable to benefit from the savings themselves.

C.5 A number of submissions raised concerns regarding economies of scale. One claims that retailers in NI benefit from the economies of scale associated with being part of the massive UK market with its 60 million consumers. These economies of scale are not available to retailers in the ROI. The submission from the academic institution states that suppliers may not act consistently as retaining uniform pricing can be made difficult due to transfer pricing or the prevalence of grey market goods.

Retailer Practices and Buyer Power

C.6 Buyer power has been raised as a concern by two supplier representative bodies and two grocery wholesalers. Those submissions argue that the domestic grocery retail market is highly concentrated and the imbalance in size between suppliers and their customers gives huge buying power to the retailers.

Cost

Cost of Product

C.7 In relation to the cost of product, a number of submissions state that some international brands place the ROI at the high price end of the market. These submissions claim that ROI retailers are treated unfairly by international suppliers and their ROI agents/offices. A number of retailers, their representative body and wholesalers state that the cost of products is significantly higher in the ROI.

Cost of doing business

C.8 All of the submissions from independent retailers, wholesalers and representatives of retailers raise concerns regarding the cost of doing business in the ROI. Those submissions outlined the higher labour cost, property cost (rent), energy cost, waste management charge, professional fees, higher VAT and higher duty on alcohol and tobacco in the ROI. These submissions call on the Government to reduce the cost of doing business. Only one submission - by an academic research institute -indicates that the ROI's logistics cost for Small and Medium Sized Enterprises (SME's), transportation, distribution and inventory-holding costs are higher than the UK, but are not exceptional when compared to the European Union average.

Other Issues

C.9 One of the submissions outlined concerns that discounts being given by suppliers are not always passed on to consumers.

C.10 Three of the submissions discussed the topic of fair trade legislation such as the UK Competition Commission's Code of Practice. Those submissions request that all stakeholders in the supply chain take steps to ensure responsible trading in the food sectors.

C.11 Three submissions expressed the view that the cost of running a retail operation in the ROI is higher than as described in the recent Forfás Report.

C.12 One submission mentioned jurisdiction concerns. This submission states that the Competition Authority does not have the legal jurisdiction to address many of the issues affecting retailers and therefore, the European Commission is the relevant body for action in this area.

D. STAKEHOLDER MEETINGS

Table D.1: Meetings with Representative Bodies and State Agencies

Stakeholder	Date(s)
Forfás	26th February
Retail Excellence Ireland	5th March
Department of Enterprise, Trade and Employment	6th March
IBEC/FDII	13th March
Enterprise Ireland	13th March
IBEC/Importers	19th March
IBEC/Retail Ireland	27th March

Table D.2: Meetings with Retailers

Stakeholder	Date(s)	Sector(s)
Tesco Ireland	13th March	Grocery
Aldi Stores (Ireland)	13th March	Grocery
Lidl Ireland Gmbh	13th March	Grocery
Clerys	19th March	Clothing
Dunnes Stores	23rd March	Grocery and Clothing
Arnotts	1st April	Clothing
Boots	7th April	Non-Food
LifeStyle Sports	20th April	Clothing
Dixons	24th April	Electrical Products
Penneys	24th April	Clothing
River Island	14th May	Clothing
Marks and Spencer	25th May	Clothing

Table D.3: Meetings with Suppliers

Stakeholder	Date(s)	Sector(s)
Musgrave Group	12th March & 24th March	Grocery
BWG Foods	12th March	Grocery
Tennant & Ruttle	31st March	Grocery
Kellogg	2nd April	Grocery
Allegro	2nd April	Grocery
Nestlé	3rd April	Grocery
Unilever	6th April	Non-Food
Johnson Brothers	7th April	Grocery
Donnellys	20th April	Fresh Fruit and Vegetables
Glaxo Smith Kline	21st April	Non-Food and Pharmaceutical
Nisa Today	21st April	Beverage, other food product and non-food
Total Produce	22nd April	Fresh Fruit and Vegetables
Premier Foods	22nd April	Food
Coca-Cola	22nd April	Beverage
United Drug	24th April	Pharmaceutical
Uniphar	27th April	Pharmaceutical

E. THE LAW AND DISTRIBUTION ARRANGEMENTS

Introduction

E.1 This Appendix provides an overview of the variety of distribution arrangements that can exist in the supply of consumer products for retail sale, and the various competition law provisions applicable to these arrangements. It begins with a description of each of the potential arrangements according to its legal characteristics and the economic rationale for selecting such an arrangement. It continues with an overview of the competition law provisions that may apply to these arrangements, namely:

- Section 4 of the Act and Article 81 of the Treaty, which prohibit agreements which prevent, restrict or distort competition;
- Section 5 of the Act and Article 82 of the Treaty, which prohibit abuse of a dominant position by undertakings; and
- The Competition (Amendment) Act 2006 ("the Amendment Act"), which prohibits certain activities of operators in the grocery supply chain.

E.2 While sections 4 and 5 of the Act and Articles 81 and 82 of the Treaty[3] are general in their application, the Amendment Act covers only undertakings involved at any level in the chain of supply relating to a subcategory of groceries defined as *food and drink for human consumption*.

E.3 The purpose of this overview is not to provide a comprehensive description of relevant guidelines and jurisprudence relating to distribution arrangements, but to indicate in some basic terms what behaviours are most likely to raise concerns under Irish and European competition law and what are the principal considerations.

The European Context

E.4 The European Union is based on the concept of a common market that allows for the free movement of goods and services between all Member States.[4] The principal objective of the competition provisions of the Treaty is to eliminate all obstacles to the free movement of goods or services within the common market and thus to confirm and safeguard the unity of this market.[5] To achieve this objective, the competition provisions lay down a series of rules intended to remove and prevent any market partitioning, in order to facilitate free movement. Accordingly, any form of market partitioning raises serious questions in terms of compliance with European competition law.

E.5 Against this background, it is worth recalling the nature of the allegations that have been invoked to explain the retail pricing differential to be found between NI and the ROI. It has been claimed that some suppliers are imposing higher costs on retailers operating in the ROI, and, furthermore, imposing structural barriers that impede retailers in the ROI from sourcing cheaper goods from other Member States. Market partitioning of this nature would not only be incompatible with the competition law provisions to be discussed

[3] Hereafter referred to simply as "Article 81" and "Article 82".
[4] See Article 3 of the Treaty.
[5] Case 14/68 *Walt Wilhelm* [1969] ECR 1 at paragraph 5.

below, it would in fact come into conflict with the primary objective of the European Union, namely the establishment of an undistorted common market. This Report restricts itself to a discussion of the relevant provisions of European competition law, and the equivalent provisions contained in Irish competition law, but in the interests of completeness, this wider context must be borne in mind.

Varieties of Distribution Arrangements

E.6 There are many routes to market for consumer products. From the farm or factory gate to the consumer's shopping basket, a particular good may change hands on numerous occasions. Distribution and supply arrangements comprise the mechanisms by which a producer brings its goods to the market. Typically, these arrangements consist of agreements involving businesses at different levels in the chain of distribution, e.g., an agreement between a manufacturer and a wholesaler, or between a wholesaler and a retailer, and are therefore referred to as "vertical agreements".

E.7 The variety of distribution arrangements covers a wide spectrum. At one end is full vertical integration – all the steps necessary to manufacture, distribute and sell a product are carried out within a single company. At the other end is a straightforward supply arrangement, where the levels of the chain are occupied by entirely independent operators. In between these two arrangements is a spectrum of other arrangements, each characterised by an agreement which in some sense limits the behaviour of either party.

E.8 Competition law generally views vertical agreements more benignly than "horizontal agreements", i.e., agreements between competitors. This is because, firstly, vertical agreements may be the only mechanism reasonably available to a producer to bring its goods to the final consumer. Secondly, vertical distribution and supply agreements frequently improve economic efficiency within a chain of production or distribution, by facilitating better coordination between the various firms involved, leading to lower costs overall.[6]

E.9 The following forms of distribution are among those typically utilised by producers to bring their goods to the retail level.

Vertical Integration

E.10 A producer of goods may choose to self-distribute its product. This may involve establishing subsidiary companies through which distribution takes place, or retail outlets from which the producer sells its goods directly to final consumers, or through internet sales. A vertically-integrated producer thus operates at more than one level of the distribution chain, i.e., the same company functions as both manufacturer and wholesaler, for example, or manufacturer and retailer.

E.11 By vertically integrating, a firm gains greater control over the entire process by which its goods reach final consumers. This could lead to the elimination of double marginalisation (where firms at each step in the process add on their mark-up leading to two (or more) margins being earned) and other so-called "market failures", i.e., where the

[6] Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L 336/21) at paragraph 6.

market is not operating in the most efficient way possible. However, where other factors, such as knowledge of local markets, are important, vertical integration may not be the most efficient approach.

E.12 Examples of vertically-integrated retailers in the ROI include the large supermarket chains such as ALDI, Lidl, Dunnes Stores, Tesco, Marks & Spencer and Superquinn. Many high-street clothing store chains which sell single-branded clothing goods and operate multiple stores under a common fascia, such as Penneys, Topshop or River Island, also internalise their wholesale functions and thus operate on a vertically-integrated model.

Agency

E.13 Distribution by means of an agency arrangement, unlike vertical integration, involves at least two firms: the manufacturer of the goods, known as the principal, and one or more third parties, known as agents. However, an agency arrangement represents a high level of integration given that the agent performs certain functions on behalf of the principal, typically seeking and entering into contracts with customers on its behalf.

E.14 A third party is considered to act as an agent only where the third party bears essentially no risk, either financial or commercial, in relation to the activities that it carries out on behalf of the principal. No property passes to the agent under the agency agreement, and it does not directly share in the profits (or losses) of its principal's business.

E.15 Generally, where there is a genuine agency agreement in place, neither section 4 of the Act nor Article 81 would apply to the distribution arrangement. This is because the activities performed by the agent are viewed as part of the activities of the principal, and consequently, are not considered to be a separate economic activity.

E.16 Examples of retail agency arrangements in the ROI include some international cosmetics brands that are distributed to department stores through agency arrangements.

Single Branding

E.17 Single branding is a category of distribution arrangements premised on the requirement that the distributor must sell mainly or exclusively products of a given brand.

E.18 This may be implemented by means of an exclusive purchase requirement, whereby the distributor is required to buy all its stock of a certain product from the relevant supplier. Exclusive purchase might arise, for example, in a distribution arrangement between a brewery and a publican, or a retailer and a supplier of petrol. The majority of petrol retailers in the ROI are independent resellers that operate under exclusive purchasing agreements with fuel companies like Esso, Texaco, Topaz, Top, Maxol and Campus, and which are affiliated to the company brand.

E.19 Alternatively, a distribution agreement may contain an explicit non-compete clause, obliging the distributor not to sell competing products. Single branding can also be achieved through what is referred to as "quantity forcing", where a distributor remains free, in principle, to sell competing products, but it is obliged to purchase a certain minimum amount of its requirements from only one supplier.

Sole or Exclusive Distribution

E.20 Sole distribution is an arrangement between a manufacturer/supplier and an individual distributor, whereby the supplier agrees with the distributor not to appoint another reseller in the distributor's territory and the distributor agrees not to sell actively into other exclusively allocated territories.

E.21 Exclusive distribution is a form of sole distribution, whereby, in addition to appointing the distributor as the sole reseller in the territory, the supplier further agrees with the distributor itself not to sell into the distributor's territory.

E.22 These forms of distribution are typically favoured by suppliers where the distributor is required to make a substantial investment in order to establish or develop a product market. The supplier is willing to grant the sole or exclusive rights to a distributor to incentivise the distributor to make the necessary investments in the supplier's product. Such investments may not be made if others could "free ride" on them, so the distributor requires a degree of protection from competition in order to safeguard this investment. In return, the distributor accepts certain restrictions on its own behaviour, including restrictions on the areas into which it can actively sell.

E.23 Examples of sole or exclusive distribution arrangements that can be found in the ROI include the distribution of some grocery products, especially foreign brands that do not sell an extensive range of products in the ROI, where the producer may appoint a single distributor for the entire territory. Some car brands are also distributed via sole or exclusive distribution arrangements in the State.

Selective Distribution

E.24 Selective distribution is another distribution arrangement which seeks to limit the number of distributors of a product. Selective systems have two distinctive features. Firstly, distributors are selected by the manufacturer on the basis of quantitative or qualitative selection criteria, i.e., by reference to quality, number or location. Secondly, there is an obligation on selected distributors not to sell, either actively or passively, to other distributors not belonging to the authorised distribution network.

E.25 Selective distribution is typically appropriate for the distribution of goods which are considered to have properties which take them out of the realm of "ordinary" products, and thus make the intervention of specialised distributors appropriate. Goods of this nature are likely to be technologically complex, have a luxury brand image or have strong safety implications.

E.26 Examples of products typically distributed by means of a selective distribution arrangement include sports clothing brands, such as Nike, whereby the retailer must meet certain qualitative conditions laid down by the manufacturers or distributors for sale of its products from the particular retail premises.

Franchise

E.27 Franchising typically contains elements of selective distribution, exclusive distribution and single branding. In addition, under a franchise distribution arrangement, the franchisor (or supplier) provides a marketing system to the franchisee (or distributor). This introduces intellectual property issues into the arrangement, with the franchisor licensing the use of a common retail brand and marketing that brand. In return, the franchisor tends to exert a greater degree of control over the franchisee (or affiliated retailer) than in a typical distribution arrangement. Affiliated retailers typically commit to purchase a proportion of their requirements from the franchisor.

E.28 Franchise arrangements are not considered to offend against competition law, provided that restrictive provisions in the franchise agreement are necessary to provide the franchisee with confidential know-how and/or to protect the identity and reputation of the franchised network.

E.29 Examples of franchise arrangements that can be found in the ROI include the many convenience store brands operated under franchised retail fascias, such as Spar, Mace, Centra and SuperValu. Stores operating under these fascias are typically independently owned, but the owner licenses use of the store name and brand, and sources at least a proportion of its wholesale requirements from the relevant wholesaler-franchisor. Musgrave and BWG are the largest wholesaler-franchisors in the ROI. Musgrave licenses the use of the Centra and SuperValu retail brands, while BWG licenses the use of the Spar and Mace retail brands.

Open Distribution

E.30 An open distribution system is one whereby the supplier is prepared to sell its goods to any distributor or retailer which requests supply, provided the outlet satisfies minimum credit ratings. The supplier may also choose to impose additional criteria beyond credit ratings, for example related to the distributor or retailer’s ability to promote sales. Provided the supplier does not seek to prevent a dealer that does not meet the additional criteria from obtaining supplies of the product indirectly, the distribution system will still be considered an “open” one.

E.31 The level of integration or the strength of the links between a supplier and its distributors in an open distribution system are minimal. While this means that the supplier has little control over the way its products ultimately get to consumers, a supplier may opt for this approach as the simplest way to get its goods to the market.

E.32 Examples of open distribution arrangements include the supply of pharmaceutical products by wholesalers to the more than 1,500 retail pharmacies licensed by the State. A cash-and-carry grocery goods wholesaler can also be considered a form of open distribution.

Anti-competitive Agreements and Concerted Practices: Section 4 of the Act and Article 81

E.33 Section 4(1) of the Act prohibits and makes void agreements between undertakings, decisions by associations of undertakings and concerted practices which have as their object or effect the prevention, restriction or distortion of competition in trade in any goods or services in the State or part of the State. [7] Article 81(1) prohibits and makes void

[7] A broad definition of the term “undertaking” is contained in section 3(1) of the Act, meaning “*a person being an individual, a body corporate or an unincorporated body of persons engaged for*

agreements between undertakings, decision by associations of undertakings and concerted practices which may affect trade between Member States to an appreciable extent and which have as their object or effect the prevention, restriction or distortion of competition within the Common Market. [8]

E.34 Both section 4(2) of the Act and Article 81(3) provide an exemption from the prohibition on anticompetitive coordination that may restrict or distort competition, where the agreement, decision or concerted practice confers sufficient pro-competitive benefits to outweigh the anticompetitive effects. For the exemption to apply, the agreement must satisfy each of four cumulative criteria set out in, respectively, section 4(5) of the Act and Article 81(3) EC.[9]

Horizontal and Vertical Agreements

E.35 Distribution and supply arrangements typically consist of vertical agreements involving businesses at different levels in the chain of distribution, for example, an agreement between a manufacturer and a wholesaler, or between a wholesaler and a retailer. Though section 4 of the Act and Article 81 are most commonly thought of as prohibiting anticompetitive horizontal or "cartel" type agreements, such as price-fixing, both provisions also apply to vertical supply and distribution arrangements, where these involve an agreement, concerted practice or decision with the object or effect of restricting competition.[10]

E.36 Vertical agreements frequently generate economic efficiencies within a chain of distribution, and so restrictive vertical agreements generally receive more favourable treatment under competition law than restrictive horizontal agreements between competing undertakings. Because vertical arrangements are more likely to satisfy the exemption criteria set out in section 4(5) and Article 81(3), the European Commission has adopted a Block Exemption Regulation on vertical agreements.[11] The Block Exemption Regulation identifies broad categories of arrangements for the distribution and supply of goods that either generally fall outside Article 81(1), – i.e., they are not considered to restrict competition, or that normally satisfy the conditions for exemption in Article 81(3), – i.e., they are on balance

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gain in the production, supply or distribution of goods or the provision of a service." This definition applies to both sections 4 and 5 of the Act, as well as the Amendment Act.

[8] For the purposes of Articles 81 and 82 EC, "*…the concept of an undertaking encompasses every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed…*" (Case C-41/90 *Hofner and Elser v. Macrotron GmbH* [1991] ECR I-1979), subject to certain exceptions for activities carried out to further the principle of solidarity and activities in the nature of the exclusive functions of a public authority. Both this definition and the definition contained in section 3(1) of the Act are most likely to cover the activities of a firm involved in the manufacture, the distribution or the retail sale of goods on the Irish market.

[9] The four cumulative conditions are as follows:

1. The agreement, decision or practice, having regard to all relevant market conditions, contributes to improving the production or distribution of goods or provision of services or to promoting technical or economic progress;
2. Consumers receive a fair share of the resulting benefit;
3. The agreement, decision or practice does not impose on the undertakings concerned terms which are not indispensable to the attainment of those objectives; and
4. The agreement, decision or practice does not afford undertakings the possibility of eliminating competition in respect of a substantial part of the products or services in question.

[10] This point was established by the European Court of Justice in Cases 56/64 and 58/64 *Consten and Grundig v Commission* [1966] ECR 299.

[11] Commission Regulation (EC) no 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L 336/21), hereafter "Block Exemption Regulation".

more pro-competitive than anticompetitive. Similarly, the Competition Authority has made a Category Declaration, identifying certain categories of agreements between suppliers and resellers that normally satisfy the conditions for exemption in section 4(5) of the Act.[12] These documents are of considerable assistance to businesses in self-assessing vertical arrangements for compliance with competition law.[13]

E.37 The Block Exemption Regulation provides a blanket exemption from competition law for agreements and practices coming within its definition of vertical agreements, subject to certain conditions.[14] It applies only to agreements or concerted practices where the market share held by the supplier does not exceed 30% of the relevant market on which it sells the goods or services.[15] It does not apply to vertical agreements between competing undertakings, for example, where two competing manufacturers agree to each distribute each others product.[16] Furthermore, it does not apply in sectors covered by a specific block exemption,[17] such as the motor vehicle exemption.[18]

E.38 The Block Exemption Regulation lists a number of restrictions considered "hardcore" in nature; any agreement containing one of these prohibited restrictions falls entirely outside the exemption. While an agreement falling outside the Block Exemption Regulation may, in theory, still satisfy the four cumulative requirements for exemption, the Commission takes the view that the individual exemption of vertical agreements containing one or more of these hardcore restrictions is unlikely.[19]

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[12] Competition Authority Category Declaration in Respect of Vertical Agreements and Concerted Practices (D/03/001), hereafter "Category Declaration". However, in view of the subject-matter of this Report, and its potential to significantly affect inter-State trade, the remainder of this chapter will deal principally with the provisions of the Block Exemption Regulation.

[13] It is no longer possible for a company to obtain the pre-approval of the Commission or the Competition Authority for an agreement that may potentially contain anticompetitive restrictions. Previously, companies could notify potentially anticompetitive agreements to the Commission, and/or the Competition Authority where appropriate, and receive "negative clearance", that is, formal assurance that an agreement did not breach competition law. Following the entry into force of Council Regulation (EC) No 1/2003 and of the Act, respectively, these notification processes have been abolished. By fitting an agreement within the conditions of the Block Exemption Regulation or the Category Declaration, contracting undertakings may have a degree of confidence in their compliance with competition law.

[14] Article 2(1) of the Block Exemption Regulation defines vertical agreements as agreements or concerted practices entered into between two or more undertakings each of which operates, for the purposes of the agreement, at a different level of the production or distribution chain, and relating to the conditions under which the parties may purchase, sell or resell certain goods or services.

[15] Article 3, Block Exemption Regulation. Where the agreement or practices involves an exclusive supply obligation, the exemption applies only if the market share held by the buyer does not exceed 30% of the relevant market on which it purchased the contract goods or services. An agreement or practice not satisfying the market share threshold may still be compatible with competition law where it can be established, on an individual basis, that the four conditions set out in Article 81(3) are each satisfied.

[16] The Block Exemption Regulation applies to some "non-reciprocal" vertical agreements between competing undertakings, meaning agreements whereby, for example, one manufacturer becomes the distributor of the products of another manufacturer, but the latter does not become the distributor of the products of the first manufacturer. Pursuant to Article 2(4), non-reciprocal agreements of this nature are exempted provided that the total annual turnover of the buyer does not exceed €100 million, or where the supplier is a manufacturer and a distributor of goods, while the buyer is a distributor not manufacturing goods competing with the contract goods.

[17] Article 2(5), Block Exemption Regulation.

[18] Covered by Commission Regulation (EC) No 1400/2002 of 31 July 2002 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector (OJ L 203/30).

[19] See the Commission Notice *Guidelines on Vertical Restraints* (2000/C 291/01) at paragraph 46. Article 5 of the Block Exemption Regulation also lists a number of individual restrictive contractual provisions that can never be exempted, namely non-compete purchasing obligations exceeding five years' (or indefinite) duration, post-term non-compete obligations and non-

Blacklist of "Hardcore" Restrictions

E.39 The blacklist of "hardcore" restrictions that are likely to breach Irish and/or Community competition law includes a variety of vertical agreements which, directly or indirectly, in isolation or taken together with other factors under the control of the parties to the agreement, are considered to have a clear anticompetitive objective. An agreement containing a restriction of this nature falls entirely outside the Block Exemption Regulation, as the restriction cannot be severed. Each category of hardcore restriction, when contained in an agreement between businesses at different levels on the distribution chain, has the potential to partition the market, thus hindering the development of the Common Market and damaging the proper functioning of the competitive process. Three categories of hardcore restrictions, each seeking to achieve an anticompetitive objective, are relevant for the purpose of this Report.[20]

Market partitioning by territory or customer

E.40 Market partitioning by territory or customer, i.e., the restriction of the territory into which, or the customers to whom, the buyer may resell the contract goods. Depending on the circumstances, this might include a situation where a manufacturer restricted a UK distributor from selling to an ROI distributor. Market partitioning may take place directly, in the form of an express contractual provision in the distribution agreement prohibiting the distributor or retailer from reselling to certain customers or to customers located in certain territories. It may also take place indirectly, e.g. through the use of discounts, bonuses or threats aimed at inducing or coercing the distributor/retailer to not sell to certain customers or to customers in certain locations.

E.41 There are a number of exceptions to the prohibition on market partitioning set out in the Block Exemption Regulation. The exceptions turn on the distinction between active and passive sales.

- Active sales are sales made by actively approaching customers inside another distributor's exclusive territory or exclusive customer group, for example by direct mailing, advertisements or promotions targeted at these customers, or by establishing a warehouse or distribution outlet in another distributor's exclusive territory.
- Passive sales are sales made in response to unsolicited requests from individual customers, including delivery of goods or services to such customers in response to an order received.

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compete obligations regarding the sale of specific competing brands in a selective distribution system. Provided, however, that the individual restrictive provision is severable from the main contract, it is possible for the remainder of the agreement to be exempted. In theory, the restrictive provision itself might also be exempted on an individual basis.

[20] The Block Exemption Regulation identifies two additional categories of hardcore restrictions, namely resale price maintenance (RPM) and restrictions on the sale by a manufacturer of spare parts. RPM involves agreements or concerted practices having as their object the establishment of a fixed or minimum resale price or a fixed or minimum price level to be observed by the buyer. It is not, however, a hardcore restriction of competition for a producer or distributor to provide a list of recommended or maximum resale prices to the buyer. Agreements that prevent or restrict end-users, independent repairers and service providers from obtaining spare parts directly from the manufacturer of these spare parts are also considered to be hardcore restrictions of competition falling outside the protection of the Block Exemption Regulation. Neither of these categories is of relevance to this Report.

E.42 The exceptions mean that the following restrictions, which may involve market partitioning to a certain extent, are not considered to be hardcore restrictions of competition, namely:

- A prohibition on actively reselling the contract good into a territory or to a customer group that has been reserved exclusively to the producer/distributor, or allocated by the producer/distributor to another buyer. However, there can be no prohibition on passive sales to such customers or to customers located in such territories. Furthermore, the restriction on active sales by the reseller cannot limit sales by customers of the reseller. So, for example, a distributor with a license to sell a manufacturer's products in the UK may be restricted from actively trying to sell to customers of the distributor with the license for the ROI, but if a customer in the ROI approaches the UK distributor, this distributor must be permitted to sell to the ROI customer;
- A prohibition on both active and passive sales by a reseller who is a wholesaler to end users;
- A prohibition on both active and passive sales by a reseller who is a member of a selective distribution system to unauthorised distributors of the same goods. For example, a high end cosmetics brand may restrict a department store from reselling its products to stores that are not approved resellers on the basis that these outlets do not fit in with the brand's strategy;
- A prohibition on both active and passive re-sales by a buyer of components (meaning goods supplied by a producer for use by the buyer as an input to produce other goods) to third parties who would use the components to manufacture goods that compete with the goods produced by the producer;

Restricting sales by retailers who are part of a selective distribution system

E.43 Selective distribution systems are not prohibited by the Block Exemption Regulation. However, it is prohibited for a producer or distributor, which operates a selective distribution system supplying retailers that sell to final consumers, to restrict either active or passive sales to end users by these retailers, i.e., the retailer must be free to sell to all end users. So, for example, the retailer must be free to advertise and to sell with the help of the internet. Nevertheless, it is not a hardcore restriction of competition for the producer or distributor to require the retailer to operate (or prohibit it from operating) from a particular premise, i.e., restrictions concerning the location of the retailer's business are not hardcore restrictions of competition.

Restricting cross-supplies between authorised distributors.

E.44 Within a selective distribution system, the distribution arrangement cannot involve an agreement or concerted practice that prohibits an authorised distributor from sourcing the contract goods from other appointed distributors within the distribution network. Every authorised distributor must remain free to obtain cross supplies from other authorised distributors, whether operating at the same level on the distribution chain as that distributor or at a different level of trade. Accordingly, exclusive purchasing (i.e., forcing the distributor to purchase supplies of the contract good only from one producer or supplier) is prohibited within a selective distribution arrangement.

E.45 Furthermore, within a selective distribution network no restrictions can be imposed on appointed wholesalers as regards their sales of the product to appointed retailers.

E.46 So, for example, if an authorised distributor operating in Munster was forced to obtain its supplies of the contract product only from a nominated distributor in the ROI, and was contractually prohibited from obtaining cross-supplies from another authorised distributor operating in NI, the selective distribution arrangement could not be exempted under the Block Exemption Regulation. If a restriction of competition stemming from this arrangement could be demonstrated, it would be necessary to establish, on an individual basis, that the four cumulative criteria laid out in section 4(5) of the Act and Article 81(3) were satisfied.

Abuse of a Dominant Position: Section 5 of the Act and Article 82

Unilateral Conduct

E.47 As outlined, section 4 of the Act and Article 81 prohibit anticompetitive coordination between two or more undertakings. Section 5 of the Act and Article 82, by contrast, focus on unilateral anticompetitive conduct, i.e., anticompetitive behaviour by a single economic entity.[21] These provisions may apply to an arrangement for the distribution and supply of goods, to the extent that the structure of the arrangement can be attributed to abusive conduct by an entity holding a dominant position in a relevant market.[22]

E.48 Section 5 of the Act prohibits the abuse by an undertaking of a dominant position in trade for any goods or services in the State or in any part of the State. Article 82 prohibits the abuse by an undertaking of a dominant position within the Common Market insofar as it may affect trade between Member States.

The Dominance Filter

E.49 The application of the competition law provisions governing abuse of dominance is highly fact- or situation-specific, and moreover far from straightforward. In terms of applying section 5 of the Act and/or Article 82 EC, it is necessary, first, to define the relevant market: a firm has to be dominant in relation to something.[23] Market definition is a tool by which to identify and define the boundaries of competition

[21] Following on from the discussion of vertical integration at paragraphs 4.10 – 4.12 above, it is worth noting that where there is only one undertaking or firm involved in a distribution arrangement, albeit possibly including several wholly-owned subsidiaries, neither section 4 of the Act nor Article 81 are applicable. A vertically-integrated undertaking cannot conclude an anticompetitive agreement with itself, but might, however, fall within the purview of the provisions on abuse of dominance.

[22] For a more detailed exposition of abuse of dominance, interested parties are referred to the Commission's discussion paper on the application of Article 82 (DG Competition discussion paper on the application of Article 82 of the treaty to exclusionary abuses, published December 2005, hereafter "DG Comp discussion paper", found online at http://ec.europa.eu/competition/antitrust/art82/discpaper2005.pdf), as well as its more recent (albeit briefer) guidance on enforcement priorities in applying Article 82 (Communication from the Commission *Guidance on the Commission's Enforcement Priorities in Applying Article 82 EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings*, published 3 December 2008, found online at http://ec.europa.eu/competition/antitrust/art82/guidance.pdf).

[23] See the Commission's *Notice on the definition of relevant market for the purposes of Community competition law* (OJ C 372/05), published 9 December 1997, for detailed guidance on market definition.

between firms. It has two dimensions: the product market and the geographic market. Having defined a relevant market, it is then necessary to establish that the particular undertaking holds a dominant position on this market. In terms of a vertical arrangement for the distribution and supply of goods, either the supplier or the buyer might be found to be dominant in a relevant market. Dominance is essentially a measure of substantial market power. The classic definition describes:

"… a position of economic strength enjoyed by an undertaking which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers, and ultimately of its consumers."[24]

E.50 In practice, the dominance limb often proves very difficult to satisfy. Market shares provide a useful first indication of the market structure and of the relative importance of the various undertakings active on the market. A large market share is regarded as strongly indicative of dominance, but high markets shares are not in themselves determinative of dominance. Instead, they must be interpreted in the light of the relevant market conditions, and in particular, the dynamics of the market and the nature of the product(s) in question. So, for example, it has to be considered whether it would be easy or difficult to establish a competing business, or whether similar alternative products are available. It must be stressed that, in many instances, no finding of dominance can be made, even though, for example, the relevant firm may be very large or active in numerous Member States.[25]

E.51 If it can be established that the relevant firm holds a dominant position, it is then necessary to consider whether it has engaged in anticompetitive abusive conduct. Firstly, it is necessary to identify conduct which may constitute an abuse under Irish and/or European competition law. Secondly, since the firm concerned may be able to defend actions by raising an "objective justification" for its actions, it is necessary to give some consideration to whether the conduct under assessment may be justified on business grounds other than the intention to eliminate a competitor from the market.

Potential Abuses and Defences

E.52 The following behaviours that may arise in the context of arrangements for the distribution and supply of goods have the *potential* to be found to constitute an anticompetitive abuse of a dominant position:

- <u>Requirements contracts</u> - the dominant supplier places an obligation on its customers to purchase from the supplier all or

[24] Case 27/76 *United Brands v Commission* [1978] E.C.R. 207, hereafter "*United Brands*", at p. 277.

[25] The wording of section 5 of the Act and of Article 82 leaves open the possibility that a position of collective dominance in a relevant market may be held by two or more undertakings acting together. However, the European courts in Case T-342/99 *Airtours plc v Commission* [2002] ECR II-2585 set a very high threshold for a finding of collective dominance, and so, in practice, it is unlikely that firms will be found to hold a market position of this nature. Consequently, this issue is not considered in any further detail here.

most of their requirements, where this has a substantially foreclosing effect on competing suppliers;[26]

- Tying - the dominant supplier forces its customers to purchase the goods for which it is dominant together with other goods or services for which it is not;[27]
- Certain discounts and rebates offered by a dominant firm, such as loyalty rebates conditional upon the acceptance of exclusive dealing or requirements clauses,[28] rebates linked to individualised targets over an extended period[29] or tying or aggregated rebates;[30]
- Excessive pricing - an unfairly high price is charged by a dominant supplier or an unfairly low price extracted by a dominant buyer;
- Price discrimination - the dominant firm charges different prices to different customers for identical goods, or identical prices to different customers for different goods;[31]
- Margin squeeze - a supplier dominant in both an upstream and a downstream market charges a price in the upstream market that does not enable its competitors to operate profitably in the downstream market – the differential between e.g., the wholesale and retail price charged by the dominant firm "squeezes" any potential profit of its downstream competitors;[32]

E.53 Where abusive anticompetitive conduct has been established, the dominant undertaking may avoid a finding of abuse of dominance by establishing an objective justification for its behaviour. There are, in general, two types of potential objective justifications: where otherwise abusive conduct is necessary on the basis of objective factors outside the control of the parties involved, or where it is a loss-minimising reaction to competition from others. [33]

E.54 The dominant company might also excuse its behaviour if it can show that efficiencies brought about by the conduct outweigh the likely negative effects on competition, and so, outweigh any likely harm to consumers. The efficiency defence is, however, closely scrutinised and subject to tight conditions under Community law.[34]

Relevant Abuses in the Context of the Report

E.55 In the context of this study, in particular its background and purpose, two categories of potential abuses are of particular relevance, namely, excessive pricing and price discrimination. These abuses are therefore considered in greater detail below.

E.56 Excessive pricing consists of an unfairly high price charged by a dominant supplier or an unfairly low price extracted by a dominant buyer. While, in theory, pricing practices of this nature are prohibited by section 5 of the Act and Article 82 EC, in practice there is almost no legal precedent dealing with this potential abuse, largely because it is so difficult to determine what constitutes an unreasonable price. The

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[26] Case 85/76 *Hoffmann-La Roche* [1979] ECR 461, hereafter "*Hoffmann-La Roche*".
[27] Case C-53/92P) *Hilti v Commission* [1994] ECR I-667.
[28] *Hoffmann-La Roche.*
[29] Case 322/81 *Michelin* [1983] ECR 3461.
[30] *Hoffmann-La Roche.*
[31] See *United Brands* for the most thorough exploration of the concept of price discrimination found in Community law to date.
[32] Case T-271/03 *Deutsche Telekom AG v Commission* (Judgment of 10th April 2008).
[33] DG Comp discussion paper at paragraphs 77-83.
[34] DG Comp discussion paper at paragraphs 84-92.

European courts have taken the view that "…*charging a price which is excessive because it has no reasonable relation to the economic value of the product supplied would be… an abuse*." In order to determine whether this is the case, there is a two-stage test in Community law:

i. a cost/price analysis, considering whether the difference between the costs actually incurred and the price actually charged is excessive, <u>and if so</u>

ii. determining whether the price charged is either excessive in itself or by comparison with competitors' prices. [35]

E.57 This test is very difficult to satisfy in most cases, particularly insofar as courts and competition authorities are generally reluctant to take on the role of price regulators, since the aim of competition law is allow the market to work in the most efficient, unfettered fashion possible. There are also very considerable difficulties of proof relating to the concept of the unreasonableness of a price.

E.58 <u>Price discrimination</u> occurs when a firm charges different prices to similarly situated customers for identical goods or services. This may amount to either an "exploitative" or an "exclusionary" abuse.[36]

E.59 Framed as an exploitative abuse, price discrimination would likely be treated as an allegation of excessive pricing, i.e., unreasonable pricing at the higher level, in which case the two-stage test outlined above must be satisfied. In terms of Article 82, a claim of price discrimination based on nationality or location might also succeed, to the extent that a pricing policy may have the effect of segmenting the Common Market along national lines. It must be cautioned, however, that the case law on this question is not at all clear, nor is this a category of abuse frequently pursued under Community law.

E.60 Framed as an exclusionary abuse, that is, where the dominant firm uses methods different from normal methods of competition in order to exclude its competitors or to strengthen its dominant position, a claim of price discrimination is more likely to be successful. It would be necessary to establish that the dominant firm had applied unequal conditions to equivalent transactions or equal conditions to non-equivalent transactions, and that the competitive process had been harmed as a result.

E.61 It is important to note that not every example of differential pricing by a dominant firm will constitute an abuse of dominance. It is necessary to establish, first of all, that the relevant customers are in fact similarly situated and/or that the goods or services in issue are identical. Even if this is the case, differential pricing can frequently be objectively justified. Discounts and rebates, for example, are often used as instruments of healthy and legitimate price competition. Volume discounts that directly reflect the efficiency of, and thus the cost savings made by, the dominant firm are generally unobjectionable.

The Amendment Act

E.62 The Amendment Act abolished the Restrictive Practices (Groceries) Order 1987 and amended the Act by the insertion of prohibitions relating to resale price maintenance, unfair discrimination and payments for advertising and shelf space in the grocery trade.

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[35] *United Brands*.

[36] See *United Brands* for the most thorough exploration of the concept of price discrimination found in Community law to date.

E.63 When reading the outline below of what is prohibited by the Amendment Act, it is important to always be aware of the following two points:

- The Amendment Act only applies to grocery good undertakings, which are defined as undertakings that are engaged for gain in the production, supply or distribution of "any food or drink for human consumption that is intended to be sold as groceries"; and
- The prohibitions only apply where the conduct has as its object or effect the prevention, restriction or distortion of competition in trade in any grocery goods in the State.

Resale Price Maintenance

E.64 Resale price maintenance (RPM) is the practice whereby manufacturers or suppliers specify fixed or minimum prices at which their goods may be resold. As the general competition law view is that retailers should be free to set their own resale prices, RPM itself is generally prohibited by the Act. Section 15B(1) of the Act, as amended by section 1 of the Amendment Act, goes further in prohibiting any <u>attempt</u> to <u>force</u> RPM. So where a manufacturer or supplier successfully gets a retailer to sell its goods at or above the specified price, there are two separate competition law breaches - the attempt to force RPM is a breach of the Amendment Act and the resulting RPM agreement is a breach of the Act, where its object or effect the prevention, restriction or distortion of competition.

Applying dissimilar conditions to equivalent transactions

E.65 Take a situation where a grocery goods undertaking, for example a supplier, trades with two or more other grocery goods undertakings, e.g., two retailers. Pursuant to the amended section 15B(2) of the Act, where transactions between the supplier and both retailers are equivalent, in terms of, for example, the quantity of goods purchased and the transport costs, it is prohibited for the supplier to discriminate between the retailers by applying dissimilar conditions to the deals.

E.66 The application of dissimilar conditions to equivalent transactions is prohibited by the Act where it is part of an agreement between undertakings and/or where the supplier is dominant. The prohibition contained in the Amendment Act catches unilateral behaviour by a non-dominant undertaking.

Payments for advertising or display

E.67 A grocery retailer or wholesaler cannot "*compel or coerce*" a supplier to pay for the advertising or display of the supplier's goods.[37] However, if there is no element of compulsion, it is not a breach to pay money for advertising or display.

Hello money

E.68 "Hello money" can be defined as money paid to a retailer by a supplier for shelf space in certain circumstances. Pursuant to the amended section 15B(4) of the Act, a retailer is prohibited from directly or indirectly compelling or coercing a supplier to pay hello money to the

[37] Section 15B(3) of the Act, as amended by section 1 of the Amendment Act.

retailer for shelf space within (a) a new retail outlet, (b) a newly expanded or extended retail outlet or (c) a retail outlet under new ownership on or within the first 60 days after its opening to the public.

E.69 As stated above, the compulsion to pay hello money only breaches the Amendment Act where that compulsion had the object or effect of preventing, restricting or distorting competition.

Concluding Comment

E.70 This section has set out the provisions of both national and European competition law as it applies to distribution agreements. The overarching principle behind European competition law, in particular, is the establishment of the internal market and prevention of the partitioning of national markets by private agreements. Any attempt to partition national markets is not only contrary to competition law but would also be contrary to a principle policy of the European Union.

E.71 In addition, the provisions of the Amendment Act are relevant to this Report. The focus of this legislation is somewhat different – it aims to prevent both suppliers from using their seller power and retailers from using their buyer power to impose unfair trading terms on their grocery trading partners.

E.72 The application of competition law to the market in the ROI is an enforcement matter, which therefore lies outside the terms of the Report.

F. NORDIC STUDY OF HIGH FOOD PRICES IN SIX NORDIC COUNTRIES – EXECUTIVE SUMMARY

Executive Summary and Conclusion

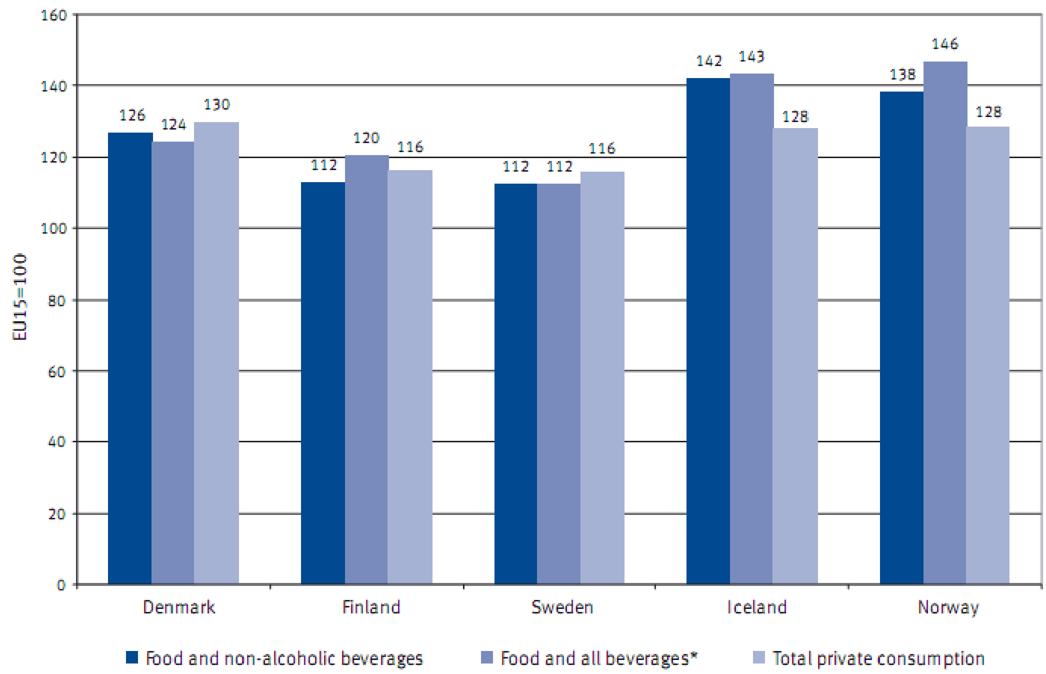
The Working Group has examined the food markets in the Nordic region. The background is that for some years Nordic food prices have been higher than the European average (EU15, i.e. EU minus the new Eastern European member states). Moreover, the assortment of food in Nordic supermarkets appear to be smaller than in other European countries.

High prices in a country means that consumers pay more for goods and services compared to other countries. This can be due to lower productivity or because the costs, such as wage level or profits are higher than elsewhere. A more restricted number of food products compared to other countries imply that consumers have less choice, that the producers' products are less likely to reach supermarket shelves, and that markets tend to be less dynamic. On that account, there have been good reasons for a closer look at how competition works in the Nordic food industry and the retail sector and at the state of market integration in the Nordic region.

Nordic food prices

According to Eurostat figures for 2004, the average prices paid by consumers for food and beverages (soft drinks and beer) bought in supermarkets in the Nordic region were between 12 per cent and 46 per cent higher than the European average, cf. fig. 1.

Figure 1. Gross food and beverages prices, 2004



Source: Eurostat and the Working Group's own calculations
Note *: Beverages, i.e. soft drinks and beer

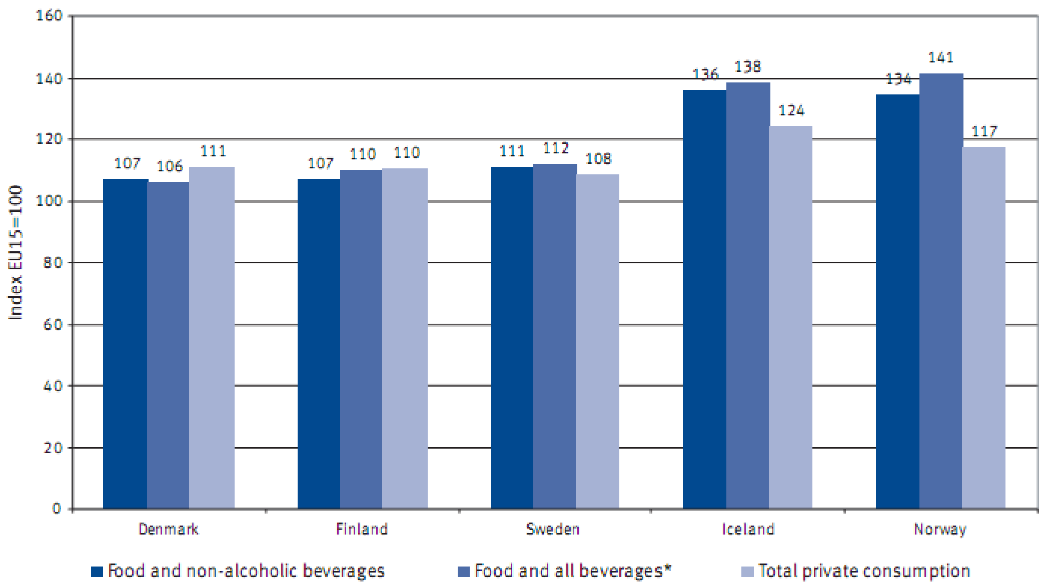
For food and beverages exclusive alcoholic beverages the price gap is smaller, between 12 per cent and 42 per cent. In Finland, Iceland, Norway and

Sweden the sales of alcoholic beverages in the supermarkets only contains beer up to 2.25 per cent alc. (Iceland), 3.5 per cent alc. (Sweden), 4.5 per cent alc. (Norway) and 4.7 per cent alc. (Finland). In these countries, the sales of alcoholic beverages are restricted, and prices on alcoholic beverages are therefore not the result of the competitive process in the food sector.

One reason for the price gap between the Nordic countries and the European average is differences in the level of taxes on the production and sale of food. VAT and excise duties on food products (for example beverages) are higher in the Nordic countries, especially in Denmark and Finland, than in the other countries in the EU. Another factor to be taken into consideration is campaigns with temporary price cuts. Short-term price campaigns are used more extensively by supermarkets in the Nordic countries, and especially in Denmark than in for example Germany and France. Short-term price cuts (a week or less) are generally not fully included in Eurostat's collection of prices.

If VAT, taxes and price campaigns[38] are deducted from the consumer prices in fig. 1, the net price differences on food and beverages are reduced to 6-12 per cent (7-11 per cent exclusive alcoholic beverages) between Denmark, Finland and Sweden (2004) and the EU15 average. Average prices in Norway and Iceland are still 38-41 per cent (34-36 per cent exclusive alcoholic beverages) higher than the European average, cf. fig. 2. There are no comparable databases of prices in Greenland or the Faroe Islands.

Figure 2. Net food and beverages prices (excl. taxes), 2004



Source: Eurostat and the Working Group's own calculations
Note *: Beverages, i.e. soft drinks and beer

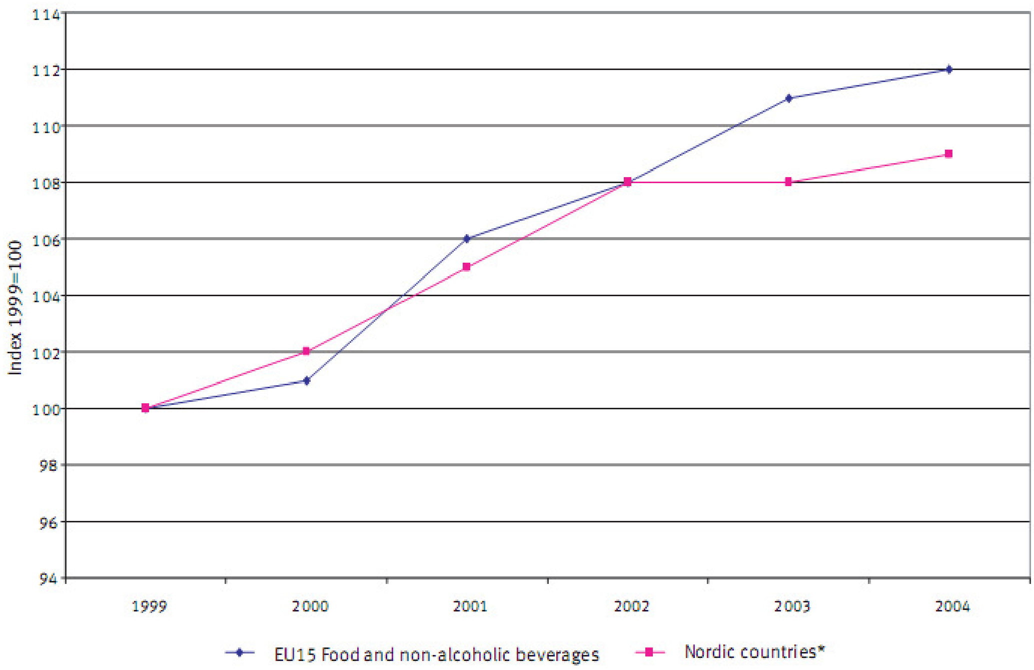
Norway and Iceland are not members of the EU and maintain tariffs and tariff-free quotas on the import of agricultural products that are also produced domestically[39]. The systems are not identical, but their effect in practice is much the same, i.e. to keep imports low in order to ensure the sale of domestic production of agricultural products which are considered of strategic

[38] The deduction of price campaigns is only done for Denmark, see chapter 2.3.
[39] There are, however, small but growing quotas for import without tariffs.

importance, for example meat and milk[40]. This regulation seems to be a main reason why the food price levels in these two countries are much higher than in the rest of the Nordic region and in Europe.

However, food and beverages (non-alcoholic) prices in the Nordic region have increased at a slower rate than in EU15[41] in the past years, cf. fig. 3. From 1999 to 2004 food prices in the Nordic markets increased by 9 per cent points, compared to an increase of 12 per cent points in EU15. Thus, the gap between the food prices in the Nordic countries and the rest of Europe has been reduced. This may indicate that competition in the food markets has improved.

Figure 3. European and Nordic food and beverages (non-alcoholic) price development



Source: Eurostat
Note*: Denmark, Finland, Iceland, Norway and Sweden

Food assortment

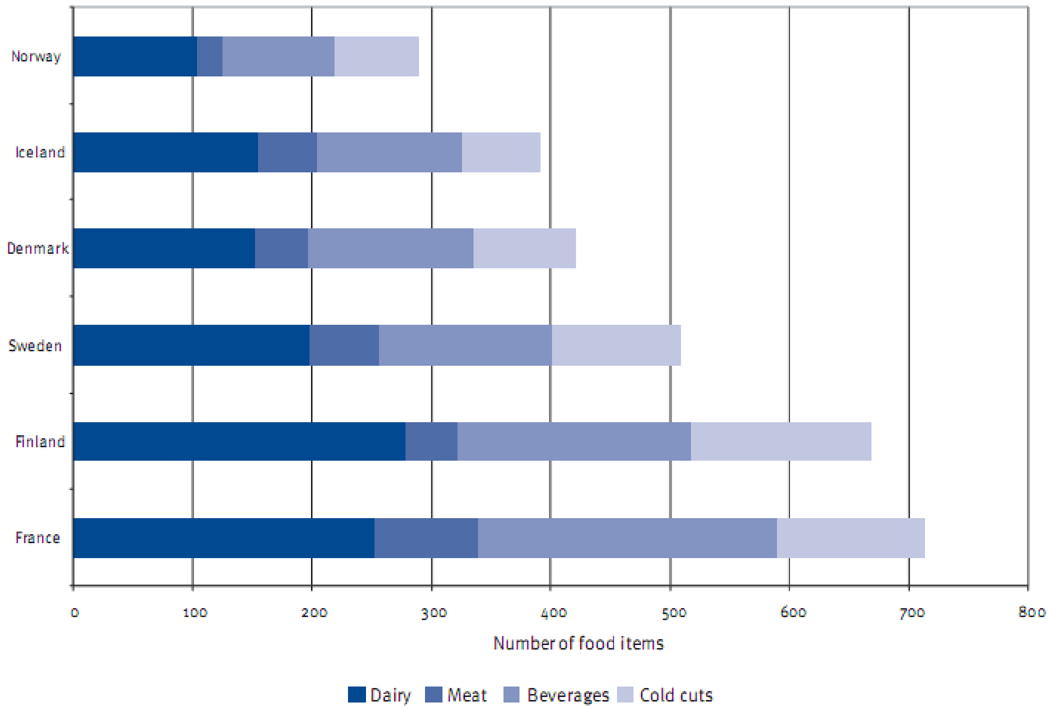
A diverse food assortment is important to consumers and a wide range of different products in grocery stores makes it easier for new and small producers to gain access to supermarket shelves. Therefore, a wide selection may make markets more dynamic and give the consumers better opportunities for trying new products.[42]

There hardly exist any comprehensive studies comparing the food assortments in supermarkets across the EU. The only exception known to the Working Group is a study by the Federation of Norwegian Agricultural Cooperation in 2005. The Working Group has therefore initiated an investigation of the ranges of food products in a sample of supermarkets in

[40] Still, there are no restrictions on the import of processed agricultural foodstuffs and products that are not produced domestically. Hence, the national import regimes explain the high prices on products subject to import restrictions, but not on all products.
[41] Price developments in Denmark, Finland and Sweden have been close to the Nordic average, whereas the rate of price increases has been somewhat faster in Iceland and slower in Norway.
[42] See chapter 2.4.

Denmark, Finland, Iceland, Norway, Sweden and France.[43] This investigation shows significant differences; consumers in Denmark, Finland, Iceland, Norway and Sweden have a much narrower choice of food than consumers in France, cf. fig. 4.

Figure 4. Number of food items in an artificial average supermarket, 2005



Source: Hornstrup and Hornstrup, 2005

Figure 4 compares the product ranges in "an artificial average supermarket"[44] in each of the countries within 4 important product groups: dairy products, beverages[45], meat and cold cuts. The results within each of these product groups differ somewhat, but overall the investigation shows a wider selection of products in France than in any of the Nordic countries.

Two explanations are likely for these differences. First, the retail structure is different in France than in the Nordic countries. Since larger stores have more products the differences are, in part, explained by differences in retail structure. Second, the evidence suggests that a food store in France in general has more choice to offer consumers compared to a similar food store in any of the Nordic countries.

The investigation on the range of food products is based on a limited sample of supermarkets and the results are thus somewhat uncertain. However, the investigation indicates that Iceland and Norway seem to have, in addition with comparably high price levels, a narrower assortment of food compared to France. The same holds for the Nordic EU members Denmark, Finland and Sweden although the differences are smaller. The results regarding

[43] See chapter 2.4.
[44] In the present investigation "an artificial average supermarket" is calculated for each country as an average of the results from the supermarkets, hypermarkets and discount markets in the country in question weighted with their national market shares.
[45] Non alcoholic and alcoholic beverages where alcoholic beverages include beverages with up to 2.25 % alc. (Iceland), 3.5 % alc. (Sweden), 4.5 % alc. (Norway) and 4.7 % alc. (Finland).

assortment from a recent Norwegian study[46] show a somewhat different picture.

The retail sector

During the past 10-20 years the supermarket sector[47] has expanded and integrated horizontally and vertically. Today, supermarkets account for 80-90 per cent of retail sales of food in all the Nordic countries and the EU. At the same time the shops have grown - the total shop space within the supermarket sector has increased in all the Nordic countries between 1995 and 2003, most in Finland (20 per cent) and least in Norway (4 per cent).

Each of the Nordic countries has more shops per 10,000 inhabitants than, for example, Germany, the UK or the Netherlands. At the same time the population density (cap/km^2) is sparse compared to the other European countries, except in Denmark, but as most households live in urban areas where supermarkets are located, this does not change the fact that most Nordic consumers have, in international comparison, good access to retail stops.

Today, nearly all supermarkets are organised in different chains or groups where all the stores in the same chain appear alike. Customers can to a high degree find similar ranges of products in all shops belonging to the same chain and at the same (maximum) prices. However, within some chains the range of products can - to a limited degree – fluctuate from shop to shop, e.g. with products from local suppliers.

Each chain tries to build up a special profile, distinct from the competitors. Some chains are local or regional, but most chains are nationwide and cover all parts of a country and some have entered neighbouring countries.

Within the supermarket sector especially the discount supermarkets have expanded and increased their market shares. The success of the discount markets is due to their policy of low prices. Their product range is limited. Some of them offer as little as 600-1500 different grocery items, most of which is food and many articles are branded with the chain's own label.

In 2003 discount markets had reached a market share of 38 per cent and 51 per cent in Iceland and Norway, respectively, cf. table 1. In Sweden and Finland their market shares were considerably lower, 14 per cent and 12 per cent, respectively, but they were growing fast. Among the discount markets, the international chains, such as Aldi and Lidl, are often characterised as hard discounters due to their concept of small assortment, extremely low costs and limited services, and therefore low prices. In 2003 there were no hard discounters in Norway and Iceland. Aldi entered the Danish market in 1977, and since 2002 Lidl has opened a number of shops in Finland, Sweden, Norway (2004) and Denmark (2005).

[46] Study conducted by the Federation of Norwegian Agricultural Cooperation, 2005, cf. chapter 2.4.
[47] All kinds of stores – exclusive kiosks, gas stations and speciality shops - where a household can buy all kinds of food and non food articles.

Table 1. Market shares of discount supermarkets (2003) and hypermarkets in the Nordic countries (2002) [1]

	DK	SF	IS	N	S
Discount markets	26	13	38	51	11
- of this hard discount	4	3	0	0	0,5
Hypermarkets	18	30	2	6	21

Source: Chapter 4
Note 1. The characteristics of discount supermarkets, hard discount and hypermarkets are described in box 4.2.

While the Nordic countries are well represented in international comparisons as far as the total number of discounters is concerned, they still lag behind other European countries as regards hard discounters. In Germany, hard discounters account for 26 per cent of the market, in Belgium 14 per cent, 10 per cent in the Netherlands and France.

There are also significant differences in the market shares of hypermarkets.[48] They try to gain market shares by selling a large selection of attractive products including non-food and by offering occasional price cuts on a small range of products. The share of turnover of hypermarkets in Iceland and Norway is 2-5 per cent (2002) and 20-30 per cent in Sweden and Finland. France has one of the largest hypermarket sectors in Europe accounting for approximately 50 per cent.[49]

The increasing number of discount markets and hypermarkets is part of the ongoing re-structuring and consolidation of the grocery trade in all countries. As a result marketing chains have grown larger and larger; some have reached 300-400 shops covering a whole country.

Moreover, the retail chains have concentrated their purchasing within a few organisations, often covering several chains. Today, 4-6 organisations negotiate agreements with the suppliers and make decisions on what to buy and what to put on the shelves in the supermarkets of the different chains in each of the Nordic countries. In order to achieve further volume and advantages in negotiations, some of the Nordic purchasing organisations are also part of international buying groups or organisations (for example Spar or Lidl).

Thus, today the concentration is stronger in the Nordic retail sector than in other European countries, cf. table 2.

This concentration has significantly strengthened the purchasing groups' bargaining position vis-à-vis the suppliers, leading to lower purchasing prices. Moreover, the internationalisation of retailers has led to better knowledge of foreign markets and improved possibilities for exploiting differences in national price levels and for introducing new food products at home.

The rationalisation and concentration have properly increased efficiency within retail groups. Wage costs in the Nordic countries are higher than the European average, and wages account for a significant share of total retailing

[48] In this report hypermarkets are defined as supermarkets with a sales area of more than 2,500 m^2.
[49] See chapter 4.

costs.[50] However, the supermarket chains that have expanded the most, especially the hard discounters, have significantly lower wage costs than the traditional retailers. The increasing market shares of the hard discounters are a manifestation of enhanced competition on the Nordic food markets which probably have contributed – and will contribute - to a narrowing of the difference between the Nordic price level and the European average in the near future.

This process has also contributed to make the selection of food in each chain concept more uniform than before.[51] Discount markets offer low prices and limited choice, supplemented by a growing share of non-food products, often on sale only for a limited period of time. The wide selection of food products is found in hypermarkets and supermarkets. The existence of different kinds of shops – to some degree - provide consumers with as well low prices as a rich supply of different food products.

Fewer competing chains normally mean weak competition unless markets are open with-out barriers to entry for new retailers, new shop concepts, etc.[52] Thus, the opportunities of chains with different ideas for entering the market are important. Entry of new chains requires access to suitable sites for new supermarkets, and access to supplies. New supermarkets can either be supplied from one of the existing wholesalers which runs a number of warehouses and distributions networks or they must be able to set up their own supply system with their own warehouses and logistics. As the number of wholesalers is declining, the latter approach is becoming more important. From the outset entrants are required to have the capacities to build up a whole network of stores, warehouses and their own logistics.

Also, all supermarkets belonging to the same marketing chain offer nearly the same range of products. This might be reinforced if the different chains buy from the same group of suppliers. As the supply side of the Nordic food sector is very concentrated, this is a likely to happen.

On the other hand, retailers' use of own (private) labels is on the increase.[53] However, the market shares of private labels in the Nordic countries are still low compared to, for example, Germany, France or the UK. Private labels can be regarded as an alternative to the manufacturers' own brands. Private labels are only profi table given large enough volumes.

The international discount chains Aldi and Lidl have a very high share of private labels on their shelves and the increased use in the Nordic countries is partly attributable to the progress of these chains – although also other supermarket chains are making increased use of private labels, for example Coop.

Products with private labels do frequently replace manufacturers' brands. However, it is not clear whether overall choice for consumers is affected negatively. Private labels are typically cheaper than the manufacturers' brands. At the same time it is more difficult for consumers to compare the prices of private labels than the prices of manufacturers' own brands bearing

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[50] Chapter 4, table 4.6.

[51] In capital chains (see box 4.1) the chain decide which products to buy for all members of the chain. In voluntary chains each member of the chain has some degree of freedom to choose from the assortment decided
on by the chain.

[52] It should be noted that the condition for market integration in between the Nordic countries differ widely.

[53]

in mind that private labels are only found in one chain. Greater transparency and thus improved opportunities for making comparisons can be achieved through consumer information about e.g. unit prices

Food industry

On average the food industry (excl. agriculture) accounts for 14 per cent of total industry output in EU25. In Norway, Iceland and Denmark the share is significantly higher, 24-53 per cent[54] of industry output, whereas it is somewhat lower in Sweden and Finland, 8-10per cent.

Like the retail companies, the food industry has been through a period of consolidation and rationalisation. In order to achieve volume and reach large-scale efficiencies food companies have expanded their production facilities and entered into new alliances or merged.[55]

Thus, concentration on all the Nordic markets in the food and beverages industry has increased. Calculated on a national basis, today the leading supplier on all the main product markets holds a market share (CR1) of 50 per cent or more with a few exceptions. Concentration on the Nordic food markets is thus significantly higher than in Germany and the UK, for example, cf. table 2.[56]

Table 2. Concentration in selected food industries and in retailing 2002/03

	DK	SF	N	S	IS	D	UK
Sale of CR1[1]							
Pig meat (%)	70	40	60[2]	60	na	‹10	20
Liquid milk (%)	85	80	95	60	42*	‹5	30
Bread (%)	55	30	30	35	na	‹5	-
Bereiages (%)	65	45	55	45	40	‹10	‹25
Retail							
CR1 (%)	35	35	35	45	45	25	25
CR3[1] (%)	90	80	80	90	82	60	60
HHI[1]	0.28	0.26	0.26	0.32	0.28	0.16	0.15

Source: The Nordic Competition Authorities
Note 1. CR1 = market share of the leading market player; CR3 = market share of the three largest market players
HHI: = Sum of the squared market shares divided by 10000.
Note 2. Includes beef and mutton.
Note *. In April 2005 the two biggest dairies merged. Their combined market share is now 65 per cent.

[54] Fishing industry included.
[55] See chapter 6.
[56] In the individual cases it is necessary to make a specific partitioning of markets, which can differ from case to case. Investigations of individual cases from the food markets have shown that today some geographical markets are larger than the national territories. As an example, in 1999 the European Commission reached the conclusion that production and sale of beef in Denmark was part of a market which was larger than the Danish territory. Where this is the case, the market shares in table 2 do not provide an accurate picture of the companies' market position on all market segments (see also chapter 6).

Competition for shelf space

The increased concentration on both the supply and the retail side has had an impact on competition. It has made it possible to obtain large-scale efficiencies at each stage of the supply chain while at the same time changing the conditions for getting access to the supermarket shelves. Especially, the growing power of the large retail groups has influenced bargaining between producers and retailers.

The supermarkets try to exploit their power to their advantage. The Working Group has found[57] that this leads to lower prices from the suppliers, support for marketing, allowances to cover costs in the shop, better quality and service, joint marketing, slotting allowances, etc. In this bargaining process minor suppliers may be at a disadvantage compared to large producers with market power.

Retailers put pressure on suppliers for lower purchasing prices. They also try to utilise the knowledge they obtain from consumers' purchasing habits through a systematic mapping of sales. This means that the impact of marketing plays an increasing role in the negotiations with suppliers. As a consequence, negotiations become more complex and include new areas like joint marketing, payment for access to the shelves etc. Suppliers must be willing and able to participate in in-store activities.

This may prove difficult for minor suppliers. They can participate in the retailers' call for tenders for the production of for example private labels and they can submit tenders on equal terms with the large suppliers. Competition in such tenders may be fierce, and winning a contract provides no guarantee of continued presence on the market. An extensive use of calls for tenders by retailers may favour larger suppliers. On the other side, tenders may give small producers opportunity to get a foothold in the market. There are examples where such contracts last for more than five years.

Market integration

Historically food markets have been national, or even local, owing to among other things transportation costs, tariffs, consumer preferences for national products, different national regulations related to health and food safety issues etc. Some of these barriers to entry have been reduced or even eliminated. The progressing implementation of EU's Single

Market and modern logistics have facilitated import from EU/EEA countries, and from visits abroad consumers have become more familiar with foreign food.

It has become easier for the grocery sector's purchasing managers to find a competitive supplier abroad. Transport costs are important in regard to products of large volume and with low value per volume, but for more expensive products the large-scale economies in production can make transport of large volumes over long distances profitable. Long distances are for example no serious trade barrier in regard to cheese while it may be a serious disadvantage with regard to fresh milk.

For a long time the food industry's volume of exports in Denmark, Finland and Sweden has been considerable. At the same time the position of companies on the home market has been challenged by competitors from abroad which

[57] Cf. chapter 5.

have lower costs, including lower wage costs. In order to stay in business, they have been forced to rationalise their production or reorganise. In the same manner as retailers have introduced new structures with low costs, suppliers have also changed their organisation by outsourcing parts of the production process, moving into new niches with better opportunities, or merging.

Since 1999 imports into the Nordic countries have increased considerably. Over 4 years (1999-2003) food imports into the Nordic countries grew by more than 20 per cent, and food trade between the 3 EU members (Denmark, Finland and Sweden) increased considerably more, corresponding to 43 per cent. This indicates that Nordic suppliers have experienced increased competition from abroad, to the benefit of consumers.

Nevertheless, food imports, notably of beer, soft drinks, fresh milk and bread, remain at a modest level compared to consumption. This area, too, has seen some increase in trade across borders. Retailers in Denmark and Sweden have, for example, started to import milk from Germany.

However, although markets have become more integrated and cross-border barriers have been reduced, overall the food markets in the Nordic countries remain national with respect to the way in which they operate.

Consumers traditionally prefer food from their own country. This is not only so in the Nordic countries but throughout most of the EU. Although consumers are prepared to try new products, habits only change slowly. Therefore, most of the food found in supermarkets today is still of national origin. Less than 5 per cent of the branded packages of food are found on the shelves of supermarkets in all the Nordic countries.[58] Retailers that operate the same shop types in more than one of the Nordic countries, such as Coop Norden, Rema1000 and Netto, offer different food assortments in each country; only 10-20 per cent of the products in the shops are the same.

Retail marketing, too, is organised nationally. Marketing both creates and reflects consumer preferences which are clearly national. Moreover, there are differences due to national regulations of, for example, opening hours, advertising, sale of alcoholic products, location of shops, etc. The national character of marketing is illustrated by the fact that all chains, even international chains such as Aldi, Lidl, Netto and Rema1000, plan their food marketing on a national scale.

An increasing number of consumers take an interest in food which is produced and marketed in accordance with certain ethical values, for example animal welfare or organic farming. Such special products are more expensive to produce and can have difficulties in getting established in the market and reaching a wider circle of consumers, including consumers in other countries.

Public regulation of the food trade has been increasing as the interest in food safety and health has grown. Such regulations influence trade signicantly as they may lead to extra costs for companies which plan to export or import products from abroad. Historically, such regulation and supervision have been national affairs, but the WTO and the European Commission have taken a number of initiatives in order to ensure that they do not constitute unnecessary trade barriers.

[58] Interviews with large Danish retailers and own estimations.

The implementation of EU's Single Market has been going on for some time, and inside the EU/EEA many national systems for food safety have today been harmonised, although all the new regulations have not been fully implemented in practice (for instance regulations on additives and zoonosis). Moreover, negotiations are ongoing to establish common rules on the use of pesticides which is an important remaining unregulated area in the EU. The Danish Veterinary and Food Administration estimates that 95 per cent of food regulations within the EU/EEA will have been harmonised when negotiations on the use of pesticides are closed.

A major exception to the harmonised rules is the safeguards against salmonella which are different in the Nordic countries. The reason is that Sweden, Finland and Norway have little or no salmonella, whereas other European countries has a considerable salmonella problem. When the problems with salmonella infections in pig meat, poultry and eggs started to increase, the countries with little or no salmonella tried to keep their country clean and set up heavy control regulation on import of meat, poultry and eggs. On their entry into the EU, Sweden and Finland negotiated their own rules on salmonella control.

Norway subsequently obtained the same system as far as imports from EU countries are concerned. Thus, health considerations have resulted in an extra set of controls and made access to these markets more diffi cult for foreign exporters. Another example is the special Danish ban on certain additives (nitrate, nitrite and sulphite which in some countries are used in, for example, sausages and marmalade) which was accepted by the European Court of Justice.

Such special national regulations may reduce imports and thereby affect the price levels.

Even a total harmonisation of national regulations on food products approval, however, would not mean that the costs of public control of food products would be the same in all Nordic countries. There would still be national differences in for instance the number of veterinarians needed to ensure the necessary degree of food safety and in how they are paid. Such differences are important to the companies' cost level, but in a competitive environment they do not affect access to the market from other EU/EEA countries or the price level. Such costs of supervision and ensuring the required quality will be carried back to the producers and will not be borne by the consumers.

Food safety, healthy food and food with low fat content create a demand for transparency and thereby good labelling. The same applies to food produced to meet certain standards of soft values e.g. concerning animal welfare, the origin of food and organic farming. Such labelling systems need to follow EU/EEA standards in order to ensure market integration.

EU/EEA has introduced harmonised rules for displaying unit prices – for example prices per litre or kilo – of food. A rigorous enforcement of these rules may contribute to further increasing competition since it allows the consumer to compare the prices of different products in retailing shops.

Much attention has been paid to regulating waste packing for beer and soft drinks. All Nordic countries have developed national systems to ensure a high level of recycling of beer/soft drink cans and bottles for both refillable containers and non-refillable ones. These national systems are not harmonised, and this is a problem to market integration. The main problem is not with the breweries as long as they only have to register the packing with the national recycling company in one country and pay its fees. The problem to market integration rests with the recycling companies and with the consumers because of differences in clearing systems among countries.

Conclusions

International price comparisons are loaded with empirical diffi culties. However, the Working Group concludes that the prices consumers in the Nordic countries pay for food and beverages are higher than the European average. One reason for this is a higher level of taxes (VAT and excise duties) on the production and sale of food and beverages (soft drinks and beer) than in the rest of the EU. But even without taxes food and beverages prices in Denmark, Finland and Sweden still remain 6-12 per cent (7-11 per cent exclusive alcoholic beverages) higher than EU15 (2004). Iceland and Norway are not members of the EU and maintain tariffs on their import of agricultural products. This seems to be a major reason why food and beverages prices in Iceland and Norway are much higher – 42-47 per cent (34-36 per cent exclusive alcoholic beverages).

Nevertheless, the price gap between the Nordic countries and EU15 has narrowed in recent years. Since 1999 consumer prices in the Nordic countries have on the average grown 3 per cent less than EU15.

The Working Group concludes this development is evidence of enhanced competition on Nordic food markets. Nevertheless, the remaining price level differences suggest that there is still considerable room for improvement.

Next, the study conducted by the Working Group suggests that the assortments of food products available in supermarkets in the Nordic region are a great deal smaller than in the south of Europe (i.e. France in the present study). This is partly due to smaller average sizes of food stores in the Nordic countries and also that retail outlets of comparable size offer the consumers a more limited choice in the Nordic countries. A study initiated by the Norwegian Agricultural Cooperation from 2005 shows results which are somewhat different. Both studies are based on limited samples of supermarkets, 4 supermarkets in the Norwegian study and 36 in the study initiated by the Working Group.

Higher prices may indicate that competition in the Nordic countries is less fierce than in the rest of the EU so that production, distribution and sale of food products in the Nordic countries demand more resources, higher wages or other costs, profi ts (or, most likely, a combination hereof). The smaller assortment of products means that consumers are offered less diversity and variety of food products and that there are fewer opportunities for suppliers to get their products on the shelves in the supermarkets.

Several Nordic food companies do well on the international markets and have built up large export volumes. Part of this success has been achieved through locating the manufacturing of products where costs are low. In this way they have been able to compensate for the high cost level in the Nordic countries.

One reason behind the high food prices and the narrower food supply seems to be the high concentration on both supply and retail level in the Nordic region. The market shares of the leading suppliers in some of the largest food categories are higher in the Nordic countries than in, for example, Germany, France or the UK. The strength of the suppliers has, however, to a large extent been counterbalanced by the growing power of the large retailing groups. Today, concentration at the retail level in the Nordic countries belongs to the top end compared to other European countries.

Large companies on the supply side and among the retailers makes it possible to obtain low costs as they realise large-scale efficiencies. However, in order to ensure that such ad-vantages benefit the consumers through lower prices and development of new products, it is essential to have a competitive environment.

To achieve this, access to the market must be ensured at all levels, including access for new shops and new supermarket chains. The most successful chains in recent years have been discount markets and hypermarkets. The first have a profile of low prices, but a very limited food assortment. The latter try to attract customers through their large selection of products, incl. food, and price reductions on selected products. Thus, the Working Group concludes that the existence of different shop types may ensure low food prices as well as a wide and attractive range of products.

Next, it is not possible to ensure access to the shop shelves for all producers of food products. However, the Working Group concludes that it is important to ensure that dominant suppliers and retailers do not restrict entry to the supermarket shelves for smaller suppliers.

Consumers in all countries have traditionally been slow to change their food habits. However, an increasing number of consumers take an interest in products that meet certain high standards of ethical values (animal welfare, organic breeding, etc.). In order to get access to the market for products with such qualifications the Working Group concludes that it is important to have a system with objective labelling for such values which the consumers have confidence in. Moreover, consumers' access to objective and comparable information on food and food prices is important to ensure progress towards the best food competition standards in Europe.

Access to the market also extends to entry of food products from abroad. Food production and sale are heavily regulated to protect consumers' health and welfare, and specific regulations in each country mean extra costs on imports from abroad.

The sale of food is also regulated to protect the environment and such regulation has implication for the market access too. Each of the Nordic countries has established its own separate deposit and return system for the collection of empty bottles and cans for beverages which the suppliers must adapt to when exporting beverages to neighbouring countries. None of these systems, however, ensure the collection of empty containers imported from abroad by the consumers. For a fully integrated market the Working Group, therefore, concludes that initiatives allowing the exchange of deposits for cans and bottles among the countries are necessary.

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