Retail-related Import and Distribution Study

May 2009

The Competition Authority
An tÚdarás Iomaíochta

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 legitimate 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.

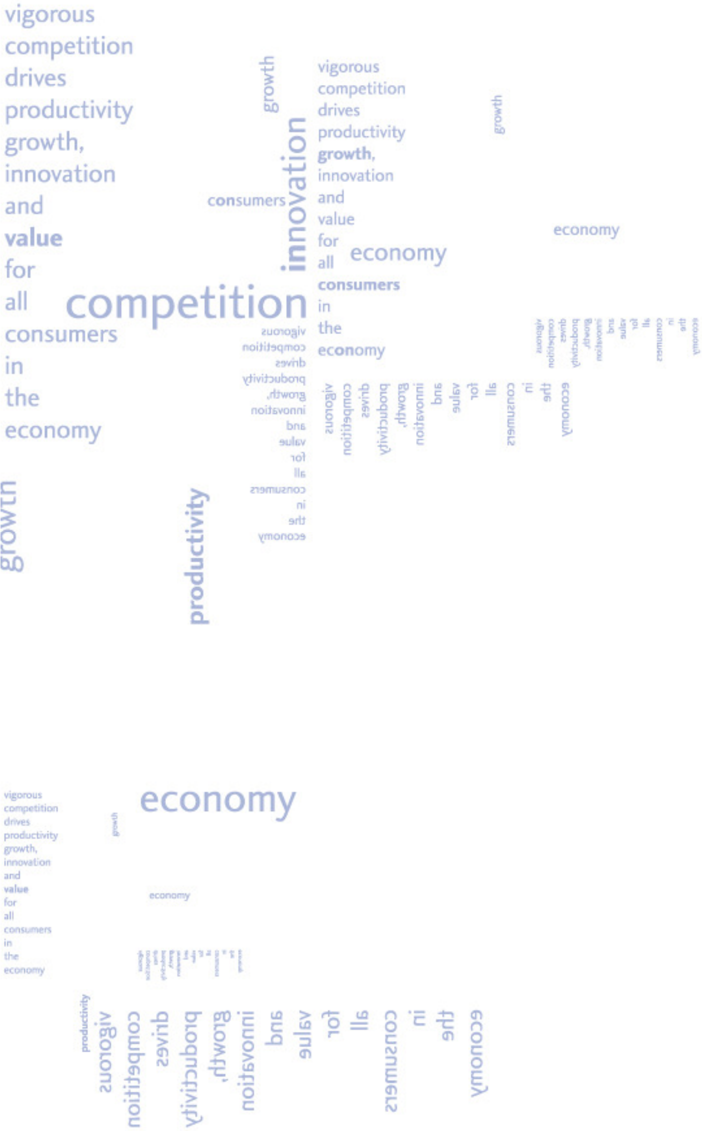
As the seasons roll on and the seasonal pattern of sales continues, all brands have the opportunity to set Republic of Ireland and Northern Ireland prices in a way that reflects more recent exchange rates.

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.



The Competition Authority, Parnell House, 14, Parnell Square, Dublin 1, Ireland
Tel: +353 (0)1 8045400 LoCall 1890 220224 e-mail: info@tca.ie

www.tca.ie