

Competition in the Retail-Related Import/Distribution Sector in Ireland

Submission to the Competition Authority from

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1.1. Efficiency, Productivity and Output Measurement Difficulty

The Irish retail sector evidenced a doubling of retail sales between 1999-2006. Employment growth of 38 percent in the sector outpaced general employment growth of 23 percent during the same period. The sales growth in the grocery sector has been supported by both price and volume growth. “Basket of goods” price comparisons make interesting headlines but a deeper evaluation is necessary before reaching definitive conclusions on whether there are abuses of market position in Ireland. The issue of whether retailers in Ireland are in a position to exercise excessive market power requires an analysis of both the Annual Services Inquiry (the most recent being 2006) and the Retail Sales Index data to reflect the distribution system based on retail sales value, sales volume, gross margin, value-added, employment (part-time & full-time), enterprise numbers and capital expenditure. Other information sources show concentration ratios as a measure of incumbent market shares e.g. Competition Authority (2008) shows outlet numbers and retail sales by vertically integrated, affiliated and independent retailers.

Interpreting the state of competition in a national retail economy is possible only to a limited extent using these data and it is difficult to reflect the productivity and efficiency of the sector. A study of the competitiveness of the Irish retail sector should not concentrate wholly on a series of input-output price comparisons: a common feature of investigations in other sectors. Competition in retail is different and embraces concerns that involve a host of non-price competitiveness issues largely absent in the debate on the competitiveness of the sector thus far. Retail is both a local and a global activity. It is multiproduct, involves heterogeneous consumer consumption patterns, with consequent demands for various distribution services and retail formats. The response of consumers to various distribution service provisions is important in generating different types of retailer offerings. This suggests that price comparison studies omitting consideration of retail service provision may fail to capture potential outlet substitution by consumers, and the impact of direct and indirect competition effects.

The recent loss of consumer confidence as evidenced by the deteriorating Consumer Confidence Index, a strengthening Euro and the peripheral location of Ireland has highlighted

the need to question the efficiency and competitiveness of the sector. The paucity of accurate and reliable statistical sources and methodological frameworks presents problems in undertaking an examination of the sector. Furthermore, analysis of public policy restrictions on nature and scale of competition (Planning and Development Act, 2000) and its consequent impact on the general competitiveness of the sector is also open to question. There appears to be both little consideration and little capacity in policy formulation to use accurate and reliable statistical data to determine the efficiency of the sector. The role of competition policy in reconciling the twin interests of markets that promote both vigorous competition and consumer choice is, in general, not addressed.

Output measures of the retail sector using gross margin and value-added measures are relatively easy to compare across sectors and countries using common industrial classification such as the NACE system in the European Union or the NAICS system in North America – both of which are not readily compatible with each other. However, even where countries use the same classification system – such as in EU countries – there may be some doubt about how different enterprises in different countries are classified. This is especially the case where retailers are engaged in activities that span two or more NACE classifications. The NACE classification system itself is not always ideally suited to the retail sector especially for non-specialised retailers. Data is sometimes available in more detail - as in the case in France – and sometimes manages to capture the character of the sector more fully.

As an alternative to cross-border basket-of-goods pricing comparisons, official data from the Annual Services Inquiry may be used to form an initial impression as to whether Irish retailing may be making comparatively excessive profits. Few really useful official retail performance statistics are currently produced for Northern Ireland. This necessitates comparisons instead with the UK as an entire statistical entity.

The three tables that follow show official figures from the Office of National Statistics in the UK compared to equivalent NACE Rev1 figures for the Republic of Ireland for the most recent year

for which figures are available for Ireland, 2006. Only the NACE classifications for which a direct comparison is available are shown.

		Gross Added Value%	
		Ireland	UK
	2006		
NACE Rev	<u>Enterprise Classification:</u>		
52.11	Non Specialised - Food Predominating	16.7%	16.2%
52.12	Non-specialised Non-food Predominating	28.2%	28.7%
52.23	Fish	23.0%	25.8%
52.3	Pharma Medical Cosmetics	26.6%	26.5%
52.41+ 42	Retail sale of Textiles and Clothing	29.6%	31.3%
52.43	Retail sale of footwear and leather goods	25.5%	31.7%
52.44	Retail sale of furniture, lighting equipment and household etc	23.2%	25.6%
52.45	Retail sale of electrical household appliances and tv. Etc	12.7%	18.5%
52.46	Retail sale of hardware, paints and glass	20.3%	24.7%
52.47	Retail sale of books, newspapers and stationery	20.2%	25.0%

Table 1 Gross Added Value as a Percentage of Turnover for Retail Enterprises

Gross Value-Added is calculated by subtracting from retail gross margins a wide range of other bought-in goods and services excluding return on invested capital. Gross margin is the difference between turnover and the cost of merchandise consumed in achieving that turnover. While gross margin figures are available for Irish enterprises, equivalent figures in respect of the UK can no longer be obtained from published official statistics and so cannot be compared.

		Payroll Costs %	
		Ireland	UK
	2006		
NACE Rev	<u>Enterprise Classification:</u>		
52.11	Non Specialised - Food Predominating	10.6%	10.9%
52.12	Non-specialised Non-food Predominating	13.1%	15.7%
52.23	Fish	13.3%	7.0%
52.3	Pharma Medical Cosmetics	14.0%	13.3%
52.41+ 42	Retail sale of Textiles and Clothing	14.5%	14.6%
52.43	Retail sale of footwear and leather goods	14.8%	16.0%
52.44	Retail sale of furniture, lighting equipment and household etc	11.9%	15.6%
52.45	Retail sale of electrical household appliances and tv. Etc	9.2%	10.5%
52.46	Retail sale of hardware, paints and glass	11.4%	14.4%
52.47	Retail sale of books, newspapers and stationery	12.3%	14.6%

Table 2: Payroll Costs as a Percentage of Turnover for Retail Enterprises

The third table shows Gross Operating Surplus as a percentage of turnover. This is calculated by subtracting payroll costs from Gross Added Value. This net figure referred to as Gross Operating Surplus may be considered a proxy for the financial metric EBITDA (earnings before interest taxation and depreciation and amortization.).

NACE Rev	Enterprise Classification:	2006	
		Ireland	UK
52.11	Non Specialised - Food Predominating	6.1%	5.4%
52.12	Non-specialised Non-food Predominating	15.1%	13.0%
52.23	Fish	9.7%	18.8%
52.3	Pharma Medical Cosmetics	12.7%	13.2
52.41+ 42	Retail sale of Textiles and Clothing	15.1%	16.7%
52.43	Retail sale of footwear and leather goods	10.7%	15.7%
52.44	Retail sale of furniture, lighting equipment and household etc	11.2%	10.1%
52.45	Retail sale of electrical household appliances and tv. Etc	3.6%	8.0%
52.46	Retail sale of hardware, paints and glass	8.9%	10.3%
52.47	Retail sale of books, newspapers and stationery	8.0%	10.4%

Table 3: Gross Operating Surplus as a Percentage of Turnover for Retail Enterprises

For the Non-Specialised categories, (52.11 and 52.12), the Irish retailers had a higher Gross Operating Surplus than UK ones. These categories include, broadly, supermarkets and department stores, which represent just under half of total turnover and about one third of total gross operating surplus in both countries. For the remaining “specialised” categories (including clothing, footwear, hardware/diy, electrical, books etc but not furniture) the Irish Gross Operating Surplus figures were lower than those of the UK for the year being considered. The data discussed here would seem to indicate a lack of a clear *prima facie* case for abnormally higher prices and suggest that the Irish retail sector is not making excessive profits – at least compared to the UK for 2006.

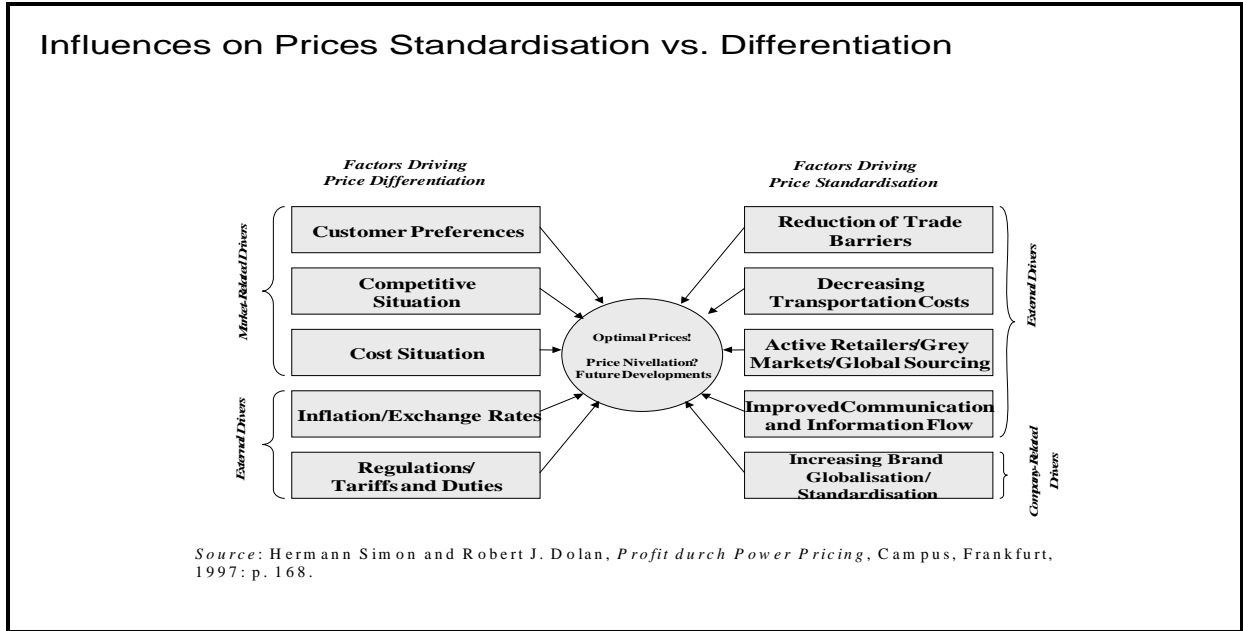
1.2. Methodological Difficulties and How Retailers' Frame International Pricing Strategies

Pricing as a retailer marketing instrument has received attention but few empirical studies have successfully captured the complexities of how retail pricing decisions are framed in an international context. The particular situation in Ireland with proximity to a different currency area, and tax regime certainly demands a greater understanding of the effects of these environmental factors on retailer pricing adjustments and decisions.

In considering why prices in Northern Ireland and the republic show considerable differences it is necessary to consider a wide range of factors:

- **Environmental factors** including levels of government regulation, price controls, inflation rates and – of particular significance here - currency exchange rates.
- **Market related factors** such as the nature of demand, income levels, the intensity of competition and relative labour costs.
- **Company internal factors** such as production / buying-in costs, channel costs, taxes, profitability measures.

In addition, it should be remembered that pricing strategy also reflects the overall corporate strategic objectives of the organization, whether it be growth, consolidation or survival. Major pricing objectives include achieving a particular rate of return, early cash recovery or indeed pricing low to prevent market entry. For multinational companies, one of the major decisions regarding pricing is whether to standardise pricing across markets or to differentiate between markets to account for national differences. Companies may not act consistently as retaining uniform pricing can be made difficult for example due to transfer pricing or the prevalence of grey markets (see Figure 1).



Companies may also adopt a “price corridor” approach to international pricing which allows for a certain band of price points rather than the incorporation of high prices in some markets and very low prices in others. This tends to result in a certain amount of compensation for price and sales variances across markets within the range identified.

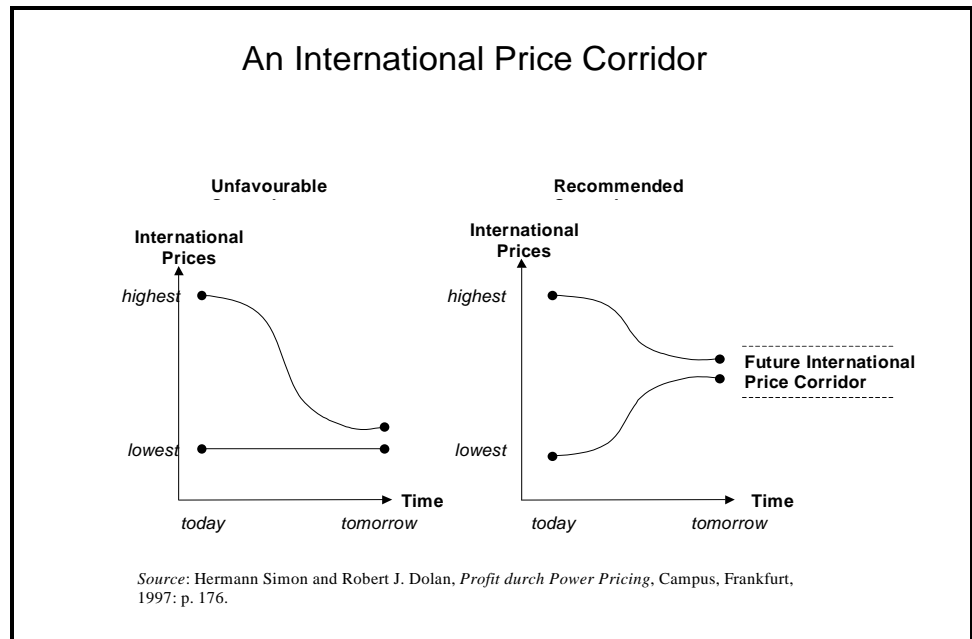


Fig 2

The concept of dual pricing – displaying both euro and sterling prices – which is commonly used in major retail chains in Ireland poses particular challenges for both retailers and consumers. Undoubtedly, the factors listed above such as varying tax rates, channel costs have an influence in requiring retailers to display dual prices.

1.3. Logistics Costs and Retail Pricing

There is generally an absence of *cost-based* aggregate logistics data gathered at a national level in Ireland. For example, the US publish an annual “State of Logistics report” covering inventory costs, transportation costs, shipping costs and logistics administration costs, but this detail is not available it would appear in Ireland. However, labour costs data do seem to be available. From the available data, it would appear Ireland’s logistics costs for SMEs (transportation, distribution and inventory-holding costs) are higher than the UK, and are not exceptional when compared to the European Union average (Boston Consulting Group (2006); World Bank (2007); Eurostat (2009) .

Sweeney et al. (2006) opine that indigenous SME’s in Ireland have developed to serve the few, large multinationals and have not invested sufficiently in making their supply chain /logistics activities more efficient. This observation is manifested in a failure to invest in IT systems relevant to the supply chain, and also a failure to manage the supply chain at an executive management level. There essentially seems to be a considerable performance gap between large multinationals and indigenous firms supplying them.

Given that logistics capabilities in Ireland are dependent on the size of the firms operating in the sector, logistics costs are largely driven by higher factor costs such as insurance, property, labour and energy. These competitiveness cost issues have been largely addressed in the National Competitiveness Report (2008). Based on our preliminary examination of available data source material and published reports on the logistics use in Ireland, it appears that the

costs of logistics are higher in Ireland compared to the UK but comparable to other EU countries. Logistics costs may in isolation prove insufficient to warrant the price differentials observed in Irish retail.

1.4. Appraising the Efficiency of a Retail Economy

The extent to which the Irish retail sector is competitive requires a more elaborate and developed understanding of how retail choice and diversity is provided at minimum total delivered price to consumers. The debate of the competitiveness of the sector is too frequently reduced to a discourse on prices charged in stores without consideration of the following issues:

- a) the economic fundamentals of viability threshold and distance range, sales densities, economies of scale and spatial distribution of population density and affluence;
- b) the elasticity and sensitivity to the provision of services by retailers to consumers;
- c) and consideration of the marginal costs facing retailers in the provision of common and specific services.

Retail price comparisons require methods to also consider all the costs facing consumers and the demand consumers have in turn for service provision. This consideration generates what is known as the total delivered price. Ireland has one of the most developed convenience grocery markets in the world and the set of services that accompany this provision (ambience, assortment, access of location, information, assurance of delivery) are reflected in the following costs: direct time and transport costs, adjustment costs, psychic costs, storage costs, information costs. The effect of how consumer demands for these service bundles surface ultimately in higher margins and retail prices. For example, a high desire for access and location on the part of Irish consumers has the effect of shifting costs from consumers to retailers and is likely to generate higher total delivered price to consumers. Irish consumers have traditionally

been provided with high access and arguably choice and format diversity of offering based on outlet per capita provision in the Irish market.

This raises interesting questions concerning the trade-off decisions on the part of consumers for access, information search costs and desires to minimise total delivered price. Do consumers actually want this level of service provision? Is there inertia in patronage patterns in Irish consumers? Are these services delivered efficiently? Are there barriers to entry to new formats and other retailers who offer different bundles of services? Are there threshold viability problems in sustaining choice in rural areas in particular when costs are rising? Are there realistic prospects for extracting economies of scale benefits in a market such as Ireland which have the effect of driving waste out of the cost of sourcing and distributing products and services in Ireland?

1.5. Implications of this Brief Analysis for the Irish Distribution System

Ireland is an island economy of only 4 million persons with maturing retail spend characteristics. Given low concentration rates in Irish retail, its finite demand possibilities owing to small size and low population density with simultaneously rising costs there may be obvious implications for retailer pricing, location and format preference. Investigation into the grocery sector needs to reflect both the costs of providing these services and possibly limited capacity to drive down the cost base by spreading of unit costs across unit sales i.e. extraction of economies of scale and management of sales densities. Our own research, in DIT School of Retail and Services Management, suggests that there is extensive scope for increased use of electronic-data-interchange and perhaps centralized distribution in non-food retail (DIT 2005). For instance, data pooling initiatives proposed by GS1 Ireland and other initiatives generally imply the need for deeper supply-chain management capacity across the retail sector is required.

No investigation of the sector would be complete without a consideration of the legitimate concerns of scale and maturity of spend, efficiency, sustainability, choice and diversity of offering across urban and rural areas. The debate around competition policy and its framing needs genuine consideration of these socio-recreational questions and ability to sustain retail services and community vibrancy around the country.

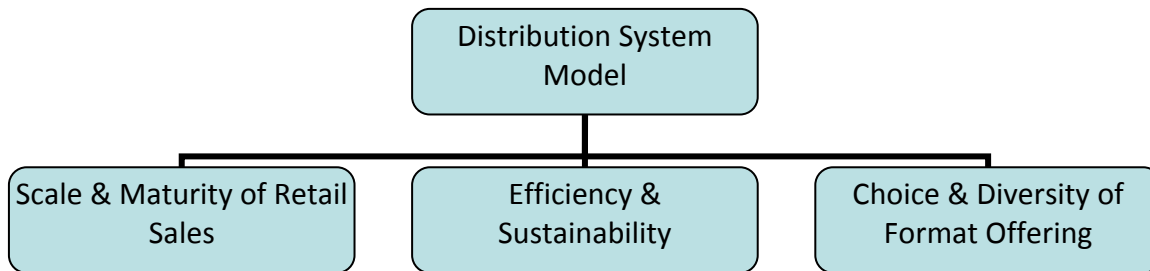


Fig 3

The market is oligopolistic and little attention has to-date been given to how current behaviour in the market may affect the grocery market structure in the future. The determination and explanation of both vertical and horizontal power where dominant multiples emerge may evidence situations where average industry costs rise/fall and returns rise/fall. At the same time service and quality levels of the retail offer remain high or increase/decrease in the short and long-run. The growth-spiral principle of retail which assumes by virtue of their ability to leverage scale and higher sales densities at an organizational level, dominant retailers lower unit costs in the short-run to a much greater extent than others in the sector. Other retailers are effectively unable to grow quickly enough and over time assume a subordinate role in their respective markets. (Note: the importance of sales density was acknowledged by the Competition Commission (2000) in the UK as a more important influence on cost structures at store level than economies of scale.)

1.6. Suggestions on the Possible Future Direction of Efforts to Monitor Competition in Irish Retail

The sales density/capacity utilization relationship is important for future market structures given the relative sales densities achieved by different organizations. To our understanding, under current land-use planning legislation, and given the “all competition is both global and local” premise acting in retail it is difficult to challenge local monopolies or regional duopolies over sites. Indeed, this point was raised in the Competition Authority (2008) report series when it referred to planning permission acting as a barrier to entry. This needs to be addressed. More critically perhaps, some consideration needs to be given to the position of ‘marginal’ retailers in the oligopoly. Would it be preferable for instance to license retailers to provide services at all urban levels and all geographic regions? It also poses questions over the regulation of competition even in small countries between national competition authorities and local authorities.

Sales density has been identified as a fundamental component of market influence in retailing as it reflects asset utilisation. The basis of competition should not be “price-fixated” but should also include the aforementioned non-price considerations. Are the appropriate metrics used in consideration for the determination and use of retailer power? The standard approaches of using margin and price are not the only ones that should be used. Consideration to the questions of food desertification and sustainability should also feature in framing competition policy.

1.7. Analysis of the Irish Retail Sector and the Absence of Relevant Statistical Data

At present the main official statistics (i.e. those produced by the Central Statistics Office) on the retail sector consist of (i) retail sales index data showing volume increases on a monthly

basis (ii) earnings data produced quarterly and (iii) the annual services inquiry usually issued in December of the year after that being covered.

The *Retail Sales Index* gives sales volume change data for various branches of retailing at NACE Rev 1 three or sometimes four digit level. In the case of one NACE classification the figure is broken out into three commodity sub-levels. The *Retail Sales Index* is of use in measuring the buoyancy of consumer demand as reflected in retail sales. These figures are produced monthly two months after the month in question.

Earnings in Distribution and Business Services are produced quarterly (one quarter after the event) and give average weekly warnings for full-time employees in enterprises with 5 or more persons engaged. Only one figure is produced for all retail (NACE code 52).

The *Annual Service Inquiry* (ASI) is the most comprehensive analysis of the retail sector and has typically been published in December two years after the year being examined. This annual report is at enterprise level and analyses retailing according to NACE Rev 1 three digit codes. A four-digit analysis has also been made available upon request. It has no geographical breakdown apart from some limited analysis as between the two Irish “planning” regions: Border-Midlands-West and Southern-Eastern.

This Annual Services Inquiry report in general contains a very wide range of data relevant to the competitiveness of the sector. This includes data by three digit NACE code on sales, purchases for resale, gross margins, gross added value, inventory levels, payroll costs, numbers engaged and employed, capital expenditure and disposals and the number of enterprises. It also provides data on eighteen specified types of bought-in goods and services, other than merchandise for resale. Among the latter include: waste disposal, insurance, travel, post and

communications and rents. This data however is only provided for the total retail sector (NACE code 52) with no sub-analysis.

Overall the Annual Services Inquiry enables performance measures to be obtained on gross margins, stockholdings or stockturns, labour costs and productivity as well as gross added value and what Eurostat calls *Gross Operating Surplus* - being Gross Added Value less labour costs. Gross Operating Surplus may be considered a reasonable proxy for the currently fashionable financial metric EBITDA (profit before depreciation, amortisation, interest and taxation) thus enabling some estimate to be made of aggregate profitability of enterprises in each three digit NACE classification.

What the Annual Services Inquiry does not collect however is any data on numbers of retail outlets or any data of retail space occupancy or any data on location of retailing¹ The absence of outlet data is hard to understand as one additional question added to the Inquiry questionnaire could enable valuable data of scale economics to be obtained on retail multiples.

Since spatial costs of premises occupancy are considered to be second only to labour costs in retailing, more effort might be made to improve information in this respect in gathering ASI data. Spatial costs will always be difficult to extract since even if rental costs are extracted in a more detailed way this would never adequately cope with instances where retailers own their own premises or where a capital sum has been paid to acquire premises at lower than market rents. Thus rental costs as disclosed in the ASI do not necessarily reflect spatial occupancy costs. The only satisfactory way to capture this important dimension is for physical space (i.e. square metres of selling space) to be collected from each respondent. This can enable economic costs of spatial occupancy to be estimated.

¹ The predecessor the five yearly Census Of Distribution last published in 1988 contained selling area data as well as very detailed geographical analysis.

One further improvement to the available data is suggested. Most financial performance metrics are related to investment levels rather than to activity levels e.g. operating profits of a firm is more meaningful as a percentage of assets employed than as a percentage of sales. In retail statistics however, no aggregate figures are gathered in respect of investment - except for inventory holdings and for capital disposals and additions. The addition of a firms fixed assets at book value would be a simple yet valuable addition to the available data and would not involve excessive collection costs by respondents to the Annual Services Inquiry.

Appendix:

Recommendations in relation to provision of additional data on retailing:

We would urge that the Central Statistics Office be encouraged to improve its retail sector data as follows:

More timely publication of the Annual Services Inquiry

Inclusion in the Annual Services Inquiry of new questions for NACE 52 (Retail sector) enterprises:

Number of outlets (or retail branches)

Total Selling Area (square metres)

Total fixed assets at book value at last balance sheet date

Some conversion measure of part-time staff into full-time staff equivalents

Improvement of Annual Services Inquiry as published as follows:

Reporting of all NACE 51 and NACE 52 data at two-decimal classification level

Including more meaningful regional analysis (not just BWM vs Remainder)

Include better description of how enterprises are classified where mixed NACE classifications are applicable to an enterprise.

List names of typical retailers included in each classification as is done in ISEE retail statistics for France and which was included in the UK's SDA25 Business Monitor (Retailing) published up to 1996.

In addition we believe that, to give better understanding of the important spatial aspects of retailing, some effort should be made to gather data from each enterprise on matters like:

Selling space occupied and non-selling space available.

Whether own distribution centre or central warehousing is used.

Type of locations of stores (high street, shopping centres, retail parks etc)

Types of premises occupancy (freehold, leasehold etc)

Rent and related occupancy expenses classified by NACE two digit+one decimal level