

GROCERY MARKET STUDY

Market Power of Supermarket Chains Under Scrutiny

Hong Kong Consumer Council

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Executive Summary

1. The Consumer Council (the Council) studies the foodstuffs and household necessities retailing sector; with special reference to the Council's report on supermarkets¹ published in 1994 and that concerning the state of competition between wet markets and supermarkets in 2003². The Council was also subsequently commissioned by the Government to investigate two complaint cases, related to the alleged anti-competitive practices in the grocery sector.³

2. In 2012, the Council noted several press reports on allegations made by businesses against restrictive practices on the part of supermarket chains in relation to the sale of groceries. The allegations concerned exclusionary practices, refusal to supply to competitors and inducement of resale price maintenance. The Council considered that it would be prudent to undertake a sector wide study to assess the current state of competition and to ascertain if there was prima facie evidence of restricting competition, for example: whether alleged abuse of market power was being carried out by undertakings with substantial market power⁴.

3. This study, commenced in 2012 therefore seeks to follow up the preceding studies, update relevant market information on the sector, and examine allegations of anticompetitive conduct, gleaned from industry interviews and market surveys. In summary, it is intended to:
 - (i) examine the state of competition in the Hong Kong foodstuffs and household necessities retailing sector taking into account geographic factors, product dimensions and service attributes;

 - (ii) examine the possible existence of market power of relevant players in the various relevant markets in Hong Kong; and

 - (iii) determine whether there is any prima facie evidence of anticompetitive practice as alleged through anonymous interviews with concerned parties in the sector.

¹ Consumer Council Report, *Report on the Supermarket Industry in Hong Kong*, November 1994.

² Consumer Council Report, *Wet Markets versus Supermarkets: Competition in the Retailing Sector*, August 2003.

³ Cases were mentioned in Competition Policy Advisory Group Report of 2006-2007 and 2011-2012.

⁴ According to the Second Conduct Rule of the Competition Bill, Clause 21(1) at the time, "An undertaking that has a substantial degree of market power in a market must not abuse that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong."

FINDINGS OF THE STUDY

State of Competition in the Grocery Sector

4. Any assessment of competition in the sector will only be valid where the market information on which it is based remains a reliable representation of the competitive choices available, and consumer behaviour and preferences. The average pattern of consumer purchasing behaviour evolves along with the changes of business environment, and emerging technologies and demographic factors. Therefore, the issues addressed by the preceding studies have to be revisited.

The 'relevant market'

5. The first step in assessing competition is to identify the relevant competitors in the relevant market. The key to identifying competitors that are in the same market is found in assessing the extent to which customers regard different competitors (in this case: stores selling groceries) as effective substitutes for each other. In other words, the stores that should be included in the same market are those to which customers will switch when the store at which they are currently shopping increases prices, or limits choices or decreases service levels.
6. The Council's information obtained through research and an 'Exit Survey' on competition in the sector indicates that there are two kinds of grocery shopping: (i) "one-stop grocery shopping", and (ii) "secondary shopping". One-stop grocery shopping is a highly developed form of retailing in advanced economies. Typically it refers to a convenient form of shopping for household consumption rather than for spot consumption. One-stop shopping facilitates consumers shopping in a place where a complete range of foodstuffs and household necessities is readily available for purchase without the necessity of visiting other retail outlets.
7. In other words, one-stop shopping is shopping for the bulk of satisfying a household's periodical grocery needs, carried out in a single trip and under one roof. Another form of shopping, characterised as "secondary shopping", such as purchasing at convenience stores is typically distinguished by a lower average basket spend and is usually aimed at instant consumption. This study takes the view that the average purchase of shoppers in convenience stores would be different to that in other types of grocery outlets, such as personal care chain stores, supermarket chain stores, grocery chain stores and individual drug stores.
8. The findings of the Council's Exit Survey and a Planning Department Survey provide useful insights as to whether it is appropriate to adopt "one-stop shopping for all types of grocery shopping" in Hong Kong. In the final analysis a 'two relevant market' approach is found to be most appropriate, in which there is taken to be
 - (i) one market for shopping for fresh produce and packaged food in supermarkets and wet markets; and

- (ii) another market for shopping for household products and necessities in supermarkets and other retail outlets, such as personal care chain stores and independent drug stores.
9. Supermarket chains therefore compete with different types of shops in the market for food (pre-packaged and fresh) and the market for household necessities. The degree of market power of any undertakings in these two separate markets will depend on the availability of rival stores within a geographical area, and the economy in general.

Marketplace conduct

10. Interviews with suppliers revealed that certain trade practices issues deserved further examination: First of all, it would appear that when it comes to negotiation of supply contracts, suppliers may be at a disadvantaged position vis-à-vis retailers. The former often have no bargaining power to include clauses to protect their interests, and the latter seem to impose uneven, opaque conditions for the renewal of the contracts.
11. It was found that exclusivity is sometimes required by big retailers either in the supply contract or subsequent to the contract, by exerting pressure through emails or other means of communication. Whether exclusivity limits consumer choices in the market depends on the duration of the exclusivity, and the provision of alternative choices for purchase from suppliers and retailers.
12. There is no specific indication of resale price maintenance being enforced in the industry, as suppliers tend to merely recommend prices and allow discounts. However, it appears that some retailers have tried to prevent others from offering discounts by complaining to suppliers and threatening to stop dealing with them if the suppliers do not prevent those competitors from offering the goods at a lower price to consumers. It is possible that some retailers might try to use a supplier to coordinate prices with other retailers.
13. Big retailers, in particular supermarkets, frequently engage in the production of own brand goods that compete with the other branded goods provided by their suppliers. The conduct of those retailers (who are also in this case competitors of the suppliers) in charging suppliers various fees, such as slotting fees, a contribution to the retailers' advertising expenditure, damaged goods allowances, and forcing them to take back or bear the cost of unsold goods, would consequently place the suppliers' products at a disadvantage in relation to those produced by them.

Possible Existence of Market Power

14. Market power (in some jurisdictions referred to as market dominance) is commonly associated with reference to (i) barriers to entry; (ii) the market shares of the parties involved in the relevant market; and (iii) marketplace

conduct exhibited by those alleged to have market power.

Barriers to entry

15. According to statistics from Census & Statistics Department in 1999 and 2011⁵, the number of small supermarket operators, with less than two outlets, substantially declined by 16% over twelve years. Moreover, statistics in 2011 revealed that small supermarket operators only contributed very little floor space, with less than 1%, to the total sector compared to the large operators.
16. Today many retail properties in Hong Kong are managed by The Link Real Estate Investment Trust ("The Link REIT"). Its portfolio consists of properties with an internal floor area of approximately 11 million square feet of retail space in purpose built shopping malls. Substantial price advantages, in bundling rental arrangements between the largest supermarket chain operators and the Link REIT, might not be possible between single shop operators and the Link REIT. Opportunity for new entrants to obtain suitable retail space, at similar costs experienced by the largest operators, when attempting to introduce a new supermarket is therefore assumed to be limited.
17. The strategic location decision of a retail chain is a contributing factor to the state of competition. It is understood that land use policy of the Government would to a certain extent influence the number of shopping malls in a geographical area, and therefore the possible number and location distribution of outlets in the area. Retail developments are mainly market-driven and where shopping malls and outlets are located is also susceptible to other economic factors.
18. Pedestrian flow planning could provide space for small and independent retailers at the street front level, thereby serving a function of assisting individual grocery retailers to compete with grocery chains, including supermarket chains, and fostering a different state of competition other than the one centered around shopping malls which tends to favour larger competitors.

Market shares

19. Having regard to the position taken in this study that competition in the sector can be distinguished between two relevant markets based on 'one stop shopping' and 'secondary shopping' (related to foodstuffs and household necessities), market share concerns are somewhat diminished. Concentration ratios in terms of number of outlets, which includes large supermarket chains plus mid-sized grocery stores, limited assortment discounters and wet markets, personal care chain stores, independent drug stores, are low by typical standards that have been adopted by competition authorities overseas. An assumption can therefore be made that the relevant market for retailing of foodstuffs is moderately

⁵ Census and Statistics Department, Report on Annual Survey of Wholesale, Retail and Import and Export Trades, Restaurants and Hotels, 2000 – 2012.

concentrated. Given that the two supermarket chains have a market share below 40% but above 25% respectively, arguably it cannot reject that either one does not possess a substantial degree of market power, that warrants further scrutiny. With regard to the market for retailing of household necessities, there is no strong evidence suggesting a substantial degree of market power by either of the two big supermarkets unless supermarket chains and personal care chains within the same corporate group, under the relevant market of retailing of household necessities are treated as one entity⁶.

Exercising market power

20. There are indications that the large supermarket chains are able to dictate terms to some suppliers (as noted above) and have some influence over terms that suppliers offer to smaller competitors of the supermarkets.
21. Nevertheless, after taking into account demand factors, through observations on price and non-price competition at the local level, with respect to certain geographic competitive environments, as well as price surveys, no strong evidence is observed in a sample of 120 supermarket outlets in 10 districts that demonstrates supermarket chains have used market power to affect prices, quality, or the product range of goods and services at the local market level.

Does prima facie evidence of anti-competitive conduct exist?

22. The Council exchanged correspondence and held meetings with businesses who alleged anti-competitive conduct in the sector, in an attempt to establish the veracity of the allegations. The allegations included attempts by certain chains to induce suppliers into exclusive dealing, resale price maintenance, and refusals to supply.
23. Not being an investigative body with powers to obtain information, the Council can only conclude at best that there is strong anecdotal evidence indicating that pressure has been exerted by retailer on suppliers to discipline competitors who threaten retailer's market position with rigorous price competition in the market. However, price surveys undertaken by the Council, albeit with limited access to information, do not indicate that large retailers have been taking advantage of any perceived market power to manipulate prices.
24. In future under the Competition Ordinance framework, with transparent rules and procedures, and investigative powers conferred on the Competition Commission, the various protagonists will be in a position to clarify their concerns, and defences, and the Commission will have to state its view on competition issues such as those relating to the relevant market, and whether market power actually exists.

⁶ In Hong Kong, two large corporations operate and wholly own both supermarket outlets and personal care chain store outlets in the household necessities market.

25. If certain retailers are found to possess a substantial degree of market power, further investigation could be required to see whether the Second Conduct Rule of the Competition Ordinance is applicable to the practices alleged to have taken place in the course of undertaking this study.

RECOMMENDATIONS OF THE STUDY

Allegations of anticompetitive conduct

26. With the implementation of the Competition Ordinance, the Council believes that the Competition Commission, with its investigative powers can go far beyond what the Council has achieved in this study. Moreover, the published information in this study should become a good source of reference for the Commission's investigations into any similar allegations of anticompetitive conduct, from which more significant conclusions might be drawn.

Industry self regulation

27. While this study has not found any strong evidence clearly supporting specific allegations of anticompetitive practices against supermarket chains, the Council urges the Competition Commission to look into the sector when the Competition Ordinance is fully implemented. Moreover, even if the Commission does not find any violation of the First or the Second Conduct Rule in the future, the Council is of the view that some industry self regulation measures should still be introduced to the sector simultaneously. There is strong evidence from overseas jurisdictions that self regulatory schemes are helpful to provide a satisfactory form of redress that enables market participants who are aggrieved with what they consider unfair practices in the sector to voice their concerns and to have a fair hearing, with the possibility of achieving some redress; even if a breach of competition law is not identified. For example, allegations of high-pressure tactics by retailers applied to suppliers that work against their interests but are not breaches of competition law may still be considered unfair and problematic for the efficient operation of the sector that need to be addressed through some transparent process that provides mediation.
28. At the time of its 2003 study, the Council looked into the possibility of having a self-regulatory framework with a code of conduct to facilitate better relations between suppliers and retailers in the grocery sector. This was in response to not only indications of serious concerns by some in the sector, but also a reflection of the Government's preference in having self-regulatory mechanisms to resolve business disputes, with the ultimate benefit of improving the business environment and improving consumer welfare. From what the Council can ascertain, no effective specific self-regulatory scheme has been put into place along the lines suggested by the Council at the time.
29. The Council believes that some form of industry self-regulatory scheme should be pursued now as a matter of priority. The development of a

functional trade complaint forum within the Hong Kong Retail Management Retail Association (HKRMA), that could be acceptable to all sides in the grocery sector, could be a constructive initiative to pursue.

30. The Council also sees self-regulation as a way for industry to collectively assist in ensuring compliance with competition law. For example, the self-regulatory regimes, as practiced in the supermarket sector in Australia and in the United Kingdom, are designed not to displace but rather to supplement competition law. If the market has confidence in a self-regulatory model adopted by the HKRMA for non-competition related complaint handling, this might suffice without any further need for government intervention except where there is a clear indication of contravention against the competition provisions that the Competition Commission considers worthy of legal action.
31. In future, a Code of Practice for the grocery sector based on mandatory undertakings similar to a model adopted in the United Kingdom and administered and audited by the Competition Commission or other public body should be encouraged.

Mergers and Acquisitions

32. With a cross-sector competition law currently in place in Hong Kong, there are restraints on certain forms of anticompetitive conduct, as provided in the law. However, it is noted with some concern, that a mergers and acquisitions provision does not form part of the law, except for the telecommunications sector. Any attempted acquisitions by supermarket incumbents of assets that deny new entrants an opportunity to either enter the market, or increase their presence, will therefore be excluded from preventative action by the Competition Commission.
33. In this regard, the Council notes that the Government has undertaken to review the Competition Ordinance a few years after the full implementation of the Ordinance. The Council urges the Government to consider in that review introducing a cross-sector merger control regime so that the Commission would have oversight where a merger or acquisition might arise that has a detrimental effect on consumer interest. In particular the Council considers that the Government should be in a position to act quickly if there is a merger between incumbent supermarket chains or an acquisition by any competitors of strategic assets that would impede new entry. Similar regulatory action exists in other competition law jurisdictions. So far, the power available to the Competition Commission would only be to express a concern and it would not be able to reverse or prevent the continuation of accumulation of market power.

On-going Market Research

34. Finally, the Council observed that while there are some smaller supermarket chains, and other chain stores providing specialized, as distinct from 'one stop' shopping, it is unclear as to how strong they are in challenging the major chains' pricing and supply decisions. It is therefore important to keep monitoring the market. Increased concentration in

relevant markets, and persistent complaints in the sector alleging misuse of market power do not enhance business confidence nor encourage vibrant business development in the grocery sector. The need to apply pro-active measures to safeguard market competition will only become apparent if the sector is being constantly monitored through independent and rigorous market surveys and inquiries.

Chapter 1 Introduction

1.1 The Consumer Council studied the foodstuffs and household necessities retailing sector with special reference to supermarkets⁷ in 1994 and again, with special reference to the state of competition between wet markets and supermarkets, in 2003⁸. The Council was also subsequently commissioned by the Government to investigate two complaint cases alleging anti-competitive practices in the grocery sector.⁹

The Findings of the Study on Supermarkets in 2003

1.2 The Council's 2003 study found that there had been a number of significant developments in the industry since its initial report in 1994:

- (i) Wet markets had a significant share of the fresh food sector but indications of a gradual decline in consumer patronage of wet markets were being observed.
- (ii) There was a prima facie concern with the market share held by the two largest supermarket chains in the packaged foodstuffs and household necessities sector, given that there was a substantial decline of small supermarket operators by approximately 41% from 1996 to 2001. From 1993 to 2003, the two major supermarket chains had grown 29%, by number of retail outlets.
- (iii) Similar to the experience of other comparable advanced economies, complaints had been levelled at major supermarket chains by other businesses, including suppliers and competitors. For example, there had been complaints that market power was being exerted over suppliers to the effect that existing competitors were being deterred from engaging in vigorous price competition. This raised doubts as to the probable success of future new entry.
- (iv) Complaints were also received from various parties alleging attempts to induce resale price maintenance and refusals to supply.

1.3 The areas of concern in the foodstuffs and household necessities retailing sector, identified by the Council and stated in its report of 2003, identified the need to:

- (i) Improve the efficiency of the Hong Kong foodstuffs and household necessities retailing sector.
- (ii) Ensure diversity, whilst maintaining traditional strengths, in fresh produce retailing.

⁷ Consumer Council Report, *Report on the Supermarket Industry in Hong Kong*, November 1994.

⁸ Consumer Council Report, *Wet Markets versus Supermarkets: Competition in the Retailing Sector*, August 2003.

⁹ Cases were mentioned in Competition Policy Advisory Group Report of 2006-2007 and 2011-2012. The cases will be discussed further in a later chapter.

- (iii) Maintain a level playing field, responsive to the needs of all competitors.
- (iv) Ensure that consumers can have trust in the market place.

1.4 The Council recognized that there was a disparity in resources and expertise available between large retail chains and small traders, insofar as their means to improve efficiency was concerned. While supermarkets appeared to be readily adapting to the challenges ahead for the sector, the same could not be said for small to medium enterprises such as wet market traders in premises managed by the Food and Environmental Hygiene Department (FEHD) and the Housing Authority (HA).

Market Development after 2003

Improvement in FEHD's Public Markets

1.5 In 2008 the Audit Department conducted a review of the FEHD's management of public markets and recommended the Government deal with those public markets identified as having very low usage and which were not providing active retail market services¹⁰. Immediately following the publication of the Audit Department report, the FEHD conducted a utilization survey on all public markets under its management, reviewing the positioning, functions and usage of public markets¹¹.

1.6 To enhance the vibrancy of public markets, the FEHD introduced the concept of service trades, snack shops and bakeries to certain markets with vacant stalls from mid-2009. By end 2012, service trade stalls, snack stalls and bakery stalls had been fully introduced¹². In addition, various market promotion activities were carried out in both public markets and cooked food centres/markets to attract patronage. These included festive decoration and celebration activities during Lunar New Year, Tuen Ng and Mid-Autumn Festivals and Christmas, thematic exhibitions and talks with cooking demonstrations, and display of "Recipes of Chef's Daily Recommendation" in Chinese, English, Pilipino and Indonesian. An information booklet on public markets and a quarterly Market Newsletter were published for wide distribution.

Privatization of Public Wet Markets

1.7 The Government has historically played a role in maintaining wet markets. This means that from a public policy point of view it used to have a role in maintaining traditional strengths of wet markets. The Council had suggested the publicly owned wet market assets of the HA (including its other non wet market commercial properties) could be sold on the open market and their use left to the new owners as they see fit.

¹⁰ Audit Commission Report No. 51 of the Director of Audit Chapter 6 November 2008 Para 4.

¹¹ Advisory Council on Food and Environmental Hygiene *The Positioning, Functions and Usage of Public Markets* ACFEH Paper 08 2009.

¹² http://www.fehd.gov.hk/english/pleasant_environment/tidy_market/tidy_public_markets.html.

1.8 A proposal by the Housing Authority was announced in July 2003 to sell its shopping malls (which included wet market facilities) and car park assets. The stated intention behind its proposal was to divest the assets in the interests of realising the monetary value in those assets. The Council viewed this as a good opportunity to ensure that the assets were going to be used in such a way that their important role in providing competitive pressure on supermarket chains would continue into the future.

1.9 With regard to proposals towards revitalizing public wet market facilities, through unencumbered sale of government-owned assets, the HA pursued its divestment plan in respect of its retail and car parking facilities. The Government was therefore committed to improving public wet market facilities and encouraging private sector participation in line with its economic policy of upholding the principles of free enterprise and free trade¹³.

1.10 In this regard, the Council saw it necessary to impose conditions on eventual transfer of ownership, upon satisfactory demonstration of leadership within a trial period, to ensure competition in the market place. Unfortunately, the Government did not see it necessary to impose restrictions on any market players from making tenders. By that standard few conditions were imposed in the sale of the Housing Authority assets through the formation of the Link Real Estate Investment Trust (LINKREIT). This resulted in the creation of dominant powerful market entity, with the ability to impose subsequent increases in the rental cost to small traders¹⁴, with a potential damaging effect on competition.

Self-regulatory Framework

1.11 Allegations of misleading and deceptive conduct were also made at the time. The Council was concerned that consumers suffer if misleading claims and deceptive conducts exist in the market place because if the market environment was characterised by rivals engaging in misleading conduct to attract customers, then healthy competition in the market would not exist. The Council noted some precautionary measures taken by the Government in respect of the labelling of imported food products thereby assisting consumers

¹³ While HA divested retail and car-parking facilities to enable it to focus on its role as a provider of public housing in 2005, it still retained a range of commercial and retail facilities, i.e. 40 shopping centres and 20 wet markets with total floor area of about 200,000 square meters in public housing estates.

¹⁴ "According to the 2012 Annual Report of The Link REIT, the average monthly rent of shopping malls under The Link REIT increased from \$25.4 per square foot in March 2008 to \$35.8 per square foot in March 2012, representing a 41% increase. In addition,"the year-on-year growth of gross sales of shop tenants in shopping malls under The Link REIT was over 10% as at September last year, and forecast that there could be a 7% to 8% rental increase in the coming two years. On the other hand, some residents of public rental housing (PRH) in remote areas (particularly those in Tin Shui Wai and Tung Chung) have expressed the view that, due to the expensive external transport fares, they are very dependent on the shops in local shopping malls and fresh markets ...(and)... the expenses on food, education, transport, etc. have already been a very heavy burden on them (especially those households receiving social security assistance),.... The Link REIT's rental increases will lead to price increases for goods and services sold by these shops, thereby further increasing the burden on their livelihood" [quoted from a question by the Hon Kwok Ka-ki, Member of the Legislative Council on 27 March 2013.]

in having some confidence in the market. The Council also had trust that the recent introduction and enforcement of the Trade Descriptions Ordinance (Unfair Trade Practices) would curb the problems of misleading conduct that was being alleged in the marketplace.

1.12 The Council also suggested that as an option for the industry, it was worthwhile to consider a self regulatory complaints handling system where the authority could examine allegations of anti-competitive conduct in the foodstuffs and household necessities retailing sector, to address the concerns by suppliers in the grocery market that market power was being abused.

1.13 The Council has always been willing to render assistance as and when necessary to encourage self regulation. In 2004 the Hong Kong Retail Management Association (HKRMA) published a Code of Practices to Promote Competition, which was said to be in line with UK and Australian practices for supermarkets¹⁵. It is understood that all major supermarket chains agreed to comply with the Code. However, the Council observed at the time that the complaints handling process of the HKRMA within the Code was not transparent. Since that time the Council has not seen any progress in the development of a more transparent self-regulatory mechanism that would satisfy the concerns expressed following its 2003 report.

1.14 The Government and the Council acknowledged that improving the shopping environment was an important feature in the foodstuffs and household necessities retailing sector, and noted it would continue to monitor the situation closely. As a result, since 2008 the Council conducted surveys and posted pricing information online through its Retail Price Watch¹⁶ and Supermarket Price Watch services¹⁷ with the intention of facilitating informed choices by consumers.

Objectives of this Study

1.15 In 2012, the Council noted several press reports from businesses alleging restrictive practices in the sale of groceries¹⁸ in relation to supermarket chains. The allegations concerned refusals to supply and the inducement of resale price maintenance. The Council considered that if it was proven that such conduct was being carried out by undertakings with substantial market power then it would be indicative that competition in the markets in which the reference goods were supplied was being prevented, restricted or distorted in contravention of the Competition Ordinance which was being proposed for Hong Kong¹⁹.

¹⁵ See <http://www.hkrma.org/en/about/code.html>.

¹⁶ See http://www.consumer.org.hk/web/ws_en/pricewatch/weekly/index.html (services will be terminated on the 31st December 2013).

¹⁷ See <http://www3.consumer.org.hk/pricewatch/supermarket-en/>.

¹⁸ The expression 'groceries' includes only food (other than that sold for consumption in the store), drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods.

¹⁹ According to the Second Conduct Rule of the Competition Bill, Clause 21(1) at the time, "An undertaking that has a substantial degree of market power in a market must not abuse that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong."

1.16 Since the Council's 2003 report, it has identified changes in Hong Kong consumers' buying behaviour, and new entry into, and exit from the foodstuffs and household necessities sector. The foodstuffs and household necessities retailing sector is an important area of concern to consumers; hence its ongoing programme of monitoring prices of a basket of fast moving products sold in supermarkets, and generally monitoring trade practices in the sector. In view of the information collected over past years, the Council considered there was a need to update its analysis of the sector, and disseminate the research and survey work it has done, subsequent to its past reports.

1.17 The work carried out in 2012 was seen as a means of addressing the concerns of the Government that the grocery sector is operating for the benefit of consumers and for the purposes of assessing the state of competition and the change of the market structure over last 9 years in Hong Kong. This Council study therefore seeks to:

- (i) Examine the current state of competition in the in Hong Kong foodstuffs and household necessities retailing sector with respect to geographic factors, product dimensions and service attributes.
- (ii) Examine the market power of relevant players in the various relevant markets in Hong Kong.
- (iii) Determine whether prima facie evidence exists of anticompetitive conduct that had been alleged through anonymous interviews with concerned parties in the trade.

The Scope of the Study

1.18 The study is divided into two parts:

- (i) firstly, the study of market structure, examining the question of market power and whether it could be held by relevant players in the foodstuffs and household necessities sector; and
- (ii) secondly, the collation of statements from concerned parties, particularly suppliers to retail outlets, regarding allegations of anticompetitive conduct.

1.19 Investigations into anti-competitive conduct are amongst the most complex and difficult tasks that competition authorities undertake. In a typical investigation, a competition authority will usually gather information not only on the relevant supply and demand characteristics, but also evidence of communications between suppliers and purchasers and between competitors (for example, by analyzing telephone records and emails). Examples from overseas investigations illustrates how resource intensive these tasks may be:

- (i) In May 2006, the Office of Fair Trading (OFT) referred the supply of groceries by retailers in the United Kingdom to the Competition

Commission (UKCC) for investigation. It took the Competition Commission 17 months accompanied by 26 working papers leading up to the publication of provisional findings in October 2007, and its final report in April 2008.

- (ii) The Australian Competition and Consumer Commission (ACCC) analyzed more than 20 archive boxes of telephone call records and revealed more than 1600 calls between competitors in a cartel investigation.

1.20 The Council has no authority, nor the intention to conduct a formal investigation along the lines mentioned above. The Council's only function, particularly in terms of the interviews conducted with suppliers, was to interview a wide range of market participants in the sector and collate market information. The aim being to indicate whether prima facie evidence about the alleged conduct exists, which in turn may indicate harm to consumer welfare, and therefore possibly facilitate a formal future investigation by the proposed Hong Kong competition authority.

Chapter 2 Approaches Taken by Overseas Competition Studies

2.1 There have been many studies by overseas competition authorities on the state of competition in their relevant grocery markets that have focused to a large extent on the conduct of supermarkets, both before and since 2003. Those studies demonstrated that different combinations of retailers, such as household product chain stores, drug stores and groceries shops in a competitive local market environment could trigger different responses by supermarket incumbents. Evidence also showed that the competitive environment in different localities appeared to be related to the type of retail services provided by supermarket chains.

2.2 Allegations of anticompetitive conduct typically suggest that some form of illegal conduct may have arisen, within the context of a competition law. Hong Kong now has a law prohibiting anticompetitive conduct which, when fully implemented, can therefore be used to test such allegations. Nevertheless, it must also be acknowledged that many complaints concerning the conduct of market participants are not directly related to competition problems as strictly defined in competition law. The conduct complained of could be thought of as unfair, due to an imbalance of bargaining power, but this is not the same as an abuse of market power as defined under competition law. Examination of the scope and approach taken in competition studies of grocery markets conducted overseas reveals that two separate approaches have been adopted in addressing different competition issues. The issues have been examined:

- (i) either as an abuse of substantial market power as defined under competition law or
- (ii) as an unfair practice through exercising market power which while not illegal is still having an undesirable impact on the market.

The various overseas studies are summarized in the following sections.

Consumers International Report

2.3 A Consumers International (CI) 2012 report on the relationship between supermarkets and suppliers noted that over the last 30 years, supermarkets in developed economies around the world have acquired an increasing share of grocery markets, and that at a national level in many countries a large share of the grocery market was frequently in the hands of only a handful of supermarkets²⁰.

2.4 The CI Report produced a table identifying the concentration of national food markets in a number of competition law jurisdictions around the world. The table is reproduced below.

²⁰ 'The Relationship between Supermarkets and Suppliers – What are the implications for consumers?' page 3. Consumers International, April 2012.

Table 2.1: Selected National Food Market Concentration Ratios in 2008 or later²¹

Country	Year	Percentage of national food market ²²	Number of Dominant Player
Austria	2009	82	3
Belgium	2011	71	5
Denmark	2009	80	5
Finland	2011	88	3
France	2009	65	5
Germany	2011	85	4
Greece	2009	50	5
Italy	2009	40	5
Netherlands	2010	65	5
Portugal	2011	90	3
Spain	2009	70	5
UK	2011	76	4
Australia	2011	71	2
Canada	2011	75	5
Norway	2011	81	3
Switzerland	2011	76	3

2.5 The high degree of concentration in the above countries has resulted in competition agencies around the world conducting inquiries into the supermarket sector. An examination of the various studies indicates that there has been a clear distinction between:

- (i) concerns about potentially unfair trading practices, i.e. the imbalances in bargaining power of parties contracting with large retailers, such as farmers, manufacturers and suppliers; and
- (ii) concerns about conduct that would be actionable under legislative prohibitions found in competition laws - specifically the abuse of market power/dominant position, and anticompetitive vertical and horizontal conduct, and in some cases misleading and deceptive conduct.

2.6 This is particularly the case in the UK and in Australia (which has a high concentration of ownership in the sector, similar to Hong Kong). A close examination of what has transpired in relation to the two forms of conduct, in both jurisdictions, is therefore a useful case study. Accordingly, the following two sections of this chapter examine in close detail what eventuated in both of

²¹ *Op Cit* Consumers International, page 4.

²² The right hand column sets out the concentration ratio in each country, which represents the combined market share of the top X supermarkets. For example, in Austria, 82 per cent of the national food market is shared by the top three supermarkets.

those jurisdictions. For ease of reference, the material gleaned from research in relation to those two jurisdictions has been grouped under the following sub headings, which reflect the areas of concern that have been raised in Hong Kong.

- (i) *Barriers to entry* – Efforts to limit exclusivity and territorial restrictions in shopping centre leases, or other factors relating to access to retail space.
- (ii) *Mergers and acquisitions* – Measures taken to prevent high market concentration.
- (iii) *Vertical integration* – Assessments on the effect of retailer ‘generic’ brands on suppliers, and whether any action is justified.
- (iv) *Horizontal conduct* – Allegations of collusive pricing between competitors, such as co-ordinated pricing behaviour, or dominant firm price leaders where competitive fringe firms follow the price leadership of the dominant firm in the market due to the unilateral market power the dominant firm can exert and the discipline this has on unilateral pricing action.
- (v) *Abuse of market power* – Undermining competition in the sector through conduct such as predatory pricing, refusals to supply arising from resale price maintenance, or in general, being able to persistently behave in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions, to the detriment of consumer welfare.
- (vi) *Misleading and deceptive conduct* – Obtaining unfair competitive advantage through deception.

United Kingdom

2.7 In 2000, a UK Competition Commission (UKCC) report²³ found that abuses of buyer power by supermarkets had persisted for at least 10 years, and subsequently made a number of recommendations, including a Code of Practice. This subsequently proved ineffective and a second investigation was carried out in 2008²⁴. The following issues were identified.

Barriers to entry

2.8 The UKCC noted that access to suitable sites for competitors to establish outlets in competition with major stores was a significant problem. Accordingly, recommendations were made to Government and devolved regional administrations that a ‘competition test’ be applied by them as part of the planning process for proposed new stores (and proposed extensions to

²³ *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, Competition Commission, Cm4842, October 2000.

²⁴ *Groceries Market Investigation*, Competition Commission, April 2008, ISBN 978-0-11-703854-7.

existing stores). The competition test was to favour new entrants and grocery retailers other than those which already have a significant local market share²⁵. The UKCC noted it would also require grocery retailers to relinquish control over sites in highly-concentrated markets that the UKCC had identified as inhibiting entry by competing retailers. The UKCC found that under exclusivity arrangements, landowners (or developers) and in some cases local government authorities had granted exclusivity to grocery retailers agreeing not to allow other grocery retailers to operate from site(s) owned by the landowner. These exclusivity arrangements commonly arose in connection with the development of a retail parks or shopping centres²⁶.

Mergers and acquisitions

2.9 Mergers and acquisitions in the UK are governed by both EC Merger Regulation (ECMR) enforced by the European Commission for a merger with a 'community dimension' and the UK Office of Fair Trading (OFT) together with the UK Competition Commission (UKCC). The ECMR creates a compulsory notification system for mergers or acquisitions that trigger specified levels of combined aggregate turnover. Where EU merger law is not triggered, domestic merger control law set out in the UK Enterprise Act (EA) 2002 could apply.

2.10 Under the EA a merger is notified to the OFT (which may refer it to the UKCC) where it creates or strengthens a share of supply of more than a specified market share for a particular type of good or service, or involves the acquisition of a target company that has more than a specified UK turnover. These mergers or acquisitions would thereby come under scrutiny of a general competition test.

2.11 It was found that some loopholes existed that could be exploited. Apart from exclusivity arrangements retailers might have with regard to access to suitable retail sites, the UKCC also noted that a grocery retailer may be able to avoid the mergers and acquisitions competition test by buying an existing store in an area that already had the necessary planning consent for grocery retailing. This would not trigger the application of the competition test and might also avoid scrutiny by the OFT. The UKCC recommended that in order to ensure the OFT had opportunity to apply scrutiny, the acquisition by any large grocery retailer of any store with a groceries sales area above a certain number of square metres should be notified to the OFT²⁷.

Vertical integration

2.12 Vertical integration concerns were raised regarding 'own label' products, and vertical integration with convenience stores.

2.13 With regard to own label products, concerns were raised with grocery retailers' position as customers and competitors of brand manufacturers. Allegations were that in occupying both these roles, grocery retailers enjoyed significant competitive advantages in:

²⁵ *Op Cit 'Groceries Market Investigation'* para 10.9.

²⁶ *Ibid* para 7.94

²⁷ *Ibid* Para 11.12

- (i) their capacity as suppliers of own-label ranges, through their ability to control branded product manufacturers' access to market;
- (ii) the prices at which those branded goods were sold and their rates of sale (through shelf position and size); and
- (iii) being in a position to demand access to commercially-sensitive marketing and product information.

2.14 It was alleged that retailers could, in theory, reduce the ability of brand owners to realize a return on product innovation and might lead to lower levels of investment into new products in the future.

2.15 The UKCC examined a number of data sources relating to the performance of own-label goods and levels of innovation in branded products to see if there was a trend towards an increasing share of sales for own-label products. The data indicated that the sale of own-label products as a share of total grocery sales had increased substantially overall since their widespread introduction in the 1960s. However, at a product category level, there were quite different levels of own-label penetration within different categories, and, over time, own-label sales as a share of total sales had increased and decreased in different product categories. The UKCC claimed that the research suggested the advantages that grocery retailers have in selling own-label products were not sufficient to ensure growth at the expense of branded products²⁸.

2.16 In the UK, two major grocery retailers, Sainsbury's and Tesco expanded into convenience store retailing, and their success was said to be supported in large part by their existing advantages in terms of brand reputations, low purchasing prices and distribution networks. However, the UKCC did not find expansion in this sector to be anti-competitive, noting that to the extent that it had resulted in increased competition, consumers would have benefited²⁹.

Horizontal conduct

2.17 In the UK, the Office of Fair Trading (OFT) is responsible for enforcing the provisions of the *Competition Act 1998* and Article 81 of the EC Treaty in relation to explicit collusion between competitors. The UKCC on the other hand investigates tacit coordination, in the context of market investigations that are referred to it, applying theories of dominant firm price leadership and similar effects arising from oligopoly.

2.18 In relation to explicit collusion, the UKCC stated it was aware of a number of structural factors and behavioural practices in grocery retailing that could facilitate collusion. It also found that the conditions necessary for tacit coordination to arise and be sustainable may be present in UK grocery retailing. However, it observed that sustaining coordinated conduct over thousands of

²⁸ *Ibid* paraes 9.71 – 9.75

²⁹ *Ibid* para 5.91

differentiated products or choosing a smaller group of products on which to coordinate would be sufficiently complex to prevent the emergence of tacit coordination in the UK context. No evidence of large grocery retailers engaging in parallel behaviour with respect to the prices had been observed. However, it was concerned that, given the structure of the grocery retailing market, such behaviour could occur in the future³⁰.

Abuse of market power

2.19 The UKCC examined the issue of ‘below cost’ selling and allegations that this amounted to predatory pricing by large grocery retailers. The retailers freely admitted to engaging in the practice; but as a means of competing with each other. For most grocery retailers, the majority of below-cost sales related to two main product groups, i.e. dry groceries (tinned and packet goods) and alcohol. The UKCC’s approach in determining whether below cost selling was predatory was to establish whether:

- (i) convenience stores and specialist grocery stores constrained prices at the large grocery retailers’ stores;
- (ii) large grocery retailers had sufficient market power after the predation to recoup the losses incurred during the predation; and
- (iii) barriers to entry or re-entry into convenience store and specialist grocery retailing were so high that new convenience or specialist grocery stores could not open in response to a weakening of the retail offer by large grocery retailers, and nor could the threat of new entry or re-entry prevent recoupment of the losses incurred during the predation stage.

2.20 The UKCC’s conclusion was that each of these conditions was unlikely to be met other than in exceptional circumstances. Nevertheless, the UKCC acknowledged that below cost pricing could have ‘unintended’ consequences for convenience and specialist groceries, given that a major part of their product sales were the same as those targeted by major stores, i.e. alcohol and dried goods³¹.

Misleading and deceptive conduct

2.21 Suggestions had been made alleging that the practice of below-cost selling was likely to mislead consumers in relation to the overall cost of shopping at a particular grocery store. For example, that losses incurred through below cost prices on selected products (commonly referred to as ‘loss leading’) would be counteracted with increases in other products, thereby misleading consumers as to whether there was any real benefit shopping at that particular store.

2.22 The UKCC found that temporary promotions on some products to attract consumers and increase total sales could represent effective

³⁰ *Ibid* paraes 8.34 – 8.41

³¹ *Ibid* paraes 5.56 – 5.66

competition between retailers and therefore benefit consumers by reducing the average price for a basket of products.

Australia

2.23 Australia's market structure is similar to Hong Kong's in that there are two large supermarket chains that are generally regarded as dominating the grocery sector. Complaints in the sector and inquiries by the Australian Competition and Consumer Commission (ACCC) have therefore been a perennial feature of the Australian scene. A major inquiry was conducted in 2008³² and a summary of the ACCC's findings is as follows.

Barriers to entry

2.24 The ACCC found that new entrants into the sector faced significant barriers to obtaining suitable retail sites due to exclusivity clauses in the major supermarkets' leases with shopping centre owners, which precluded the owner from granting leases to competitors. The ACCC accepted that there might be justification for exclusivity clauses in order to guarantee that a supermarket, as an 'anchor tenant', will be included in a new development, thus attracting the necessary consumer traffic. However, it found that in the vast majority of leases in larger metropolitan centres there appeared to be little justification for the leases other than to prevent competitive entry.

2.25 Restrictive clauses in leases are subject to scrutiny under general competition law where they have the purpose or effect of substantially lessening competition³³. As a result of being informed of the existence of the leases, the ACCC commenced an investigation and subsequently came to agreement with the major supermarkets that they would not include restrictive provisions in any new supermarket leases, and in the case of existing supermarket leases, they would not enforce restrictive provisions five years after commencement of trading.

Mergers and acquisitions

2.26 Since 2005 the ACCC has publicly reviewed 11 transactions resulting in the acquisition of a total of 88 supermarkets, three development sites and one wholesale grocery business. The ACCC decisions and reasons, made in the context of a market characterised by two dominant supermarkets (and therefore of interest in the Hong Kong context) are available for scrutiny on the ACCC's public register³⁴.

2.27 The ACCC indicates that it uses a range of indicators including retail turnover, the number of stores operated, and retail custom (determined by consumer surveys on shopping habits³⁵) to assess levels of industry concentration for the purposes of determining (amongst other things) whether a merger or acquisition has the effect or likely effect of substantially lessening

³² Australian Competition and Consumer Commission, *Inquiry into the Competitiveness of Retail Prices for Standard Groceries*, 31 July 2008.

³³ Part IV Competition and Consumer Act 2010.

³⁴ *Op Cit*, *Inquiry into the Competitiveness of Retail Prices for Standard Groceries*.

³⁵ *Op Cit*, *Inquiry into the Competitiveness of Retail Prices for Standard Groceries*, Chapter 3.

competition. The ACCC also noted that other factors such as retail custom would be an important measure in determining the boundaries of geographic markets and corresponding acceptable levels of concentration³⁶.

Vertical integration

2.28 Similar to other jurisdictions, concerns have been raised with the presence of major supermarkets' own-label products undermining competition in specified product markets. Confidential evidence provided to the ACCC's inquiry indicated that supermarkets favoured their own-label products by giving them advantageous shelf positions, and that manufacturers of branded products could obtain advantageous product placement if they entered into contracts to supply own-label product³⁷. This conduct by itself is not prohibited but would be at risk if the contract, arrangement or understanding giving rise to the advantageous shelf placement had the purpose or effect of substantially lessening competition.

2.29 The ACCC's report did not indicate that any action in this regard was proposed, and noted that the impact of own labels on retailers' bargaining power needs to be evaluated on the evidence relating to a particular market. The ACCC noted that there is some empirical economic evidence that own-label goods do in general bestow greater bargaining power on retailers³⁸.

2.30 Vertical integration (by firms that also own supermarkets) into specialty stores (e.g. alcohol and pharmacies) and convenience stores is also a feature of the Australian sector. However, this was not identified as a major concern as far as competition and detriment to consumer welfare was concerned.

Horizontal conduct

2.31 The issue of collusive conduct between the major supermarkets is a constant area of debate in the Australian sector, driven largely by the high concentration of retailers, frequent price volatility, and bouts of price inflation. In the face of this volatility and inflation, some commentators have suggested that the supermarket duopoly that characterises the Australian food market exploits market power and charges monopoly prices to consumers.

2.32 However, an alternative view has also been proposed that an effective monopoly cannot be responsible for Australia's high rate of inflation in grocery prices. Professor Stephen King, one of the authors of the ACCC's 2008 inquiry has noted that the reason is because a monopoly sets a higher price than a highly competitive industry. The theory is that the price a monopoly sets for consumers is therefore less volatile in the face of underlying cost changes, than the price set by a highly competitive industry: "*..... Thus, if marginal costs double in a highly competitive industry, we would expect to see*

³⁶ The ACCC applies the Herfindahl–Hirschman Index by measuring the size of firms in relation to a sector as an indicator of the amount of competition among them.

³⁷ *Op Cit Inquiry into the Competitiveness of Retail Prices for Standard Groceries*, Chapter 16.8.1.

³⁸ The ACCC referred to a survey of evidence, in R Inderst and N Mazzarotto, 'Buyer power in distribution', chapter in the *ABA Antitrust Section Handbook: Issues in competition law and policy* (W D Collins, forthcoming).

the consumer price to double. But the same doubling of marginal costs in a monopoly industry will lead to a lower price rise. As a rule of thumb (based on linear demand and constant marginal cost) the monopoly price rise will be about half the highly competitive industry price rise³⁹."

Misuse of market power

2.33 There has been one major action under the misuse of market power provisions of Australian law relating to supermarkets. In this case one of the supermarket chains was found to have misused its market power to prevent competing supermarkets from discounting bread.⁴⁰ However, most debate in Australia has centred on the alleged power exercised by the two major supermarket chains to exert downward pressure on wholesale prices paid to suppliers, and charge excessive retail prices to consumers. In assessing this issue of buyer market power, the ACCC's inquiry examined a number of models applying the theory of buyer power:

- (i) The 'waterbed' effect, i.e. used to describe the result when a large player in a market demands lower wholesale prices from suppliers, forcing those suppliers to increase prices to other customers to bring earnings back to a sustainable level – (the large body in the middle of the waterbed forces up smaller bodies on the sides);
- (ii) The theory of 'virtuous' circles, i.e. where lower price retailers expand their sales further, thus enabling them to obtain even lower input prices from suppliers, which will be passed on to consumers in the form of even lower retail prices;
- (iii) The theory of vicious circles, which is the opposite of the above, and argues that ever-decreasing prices will progressively push out retailers, starting with the weakest; for example, those with the lowest retail margins. Following this argument further, as weaker retailers are progressively pushed from the market, the remaining retailers will benefit from a corresponding increase in downstream market concentration and decrease in competition. This may lead to higher prices in the long run and even progressively increasing prices if weaker retailers are pushed out of the market. There are, however, counter-objections to the vicious circle argument in that such models do not account for competition that could arise from other sources (e.g. from entry) or from expansion by an existing smaller player to occupy a market position characterised by greater product differentiation.

2.34 The ACCC has concluded that there is no consensus on any of the theories of buyer power. As a result it broadly prefers the 'bilateral bargaining power' model as the appropriate analytical framework. The reason being that the bilateral bargaining power model more closely fits the actual structural features of grocery supply markets (a series of bilateral relationships, rather

³⁹ Stephen King, 'Food Inflation and Supermarket Silliness' Core Economics – Commentary on economics strategy and more. 9 November 2009.

⁴⁰ *Australian Competition and Consumer Commission (ACCC) v Australian Safeway Stores Pty Ltd (N. 3)* (2001) 119 FCR 1.

than wholesale markets), and better predicts empirical outcomes of grocery retail supply (decreases in price often not accompanied by decreases in quantity)⁴¹.

Misleading and deceptive conduct

2.35 Misleading and deceptive conduct has not been a major area of concern in the Australian supermarket/grocery sector. Nevertheless, the two major supermarket chains, Woolworths' and Coles, both have been found to have breached relevant provisions of Australian law. Woolworths was found to have misrepresented the origin of beef sold through its stores, and the grain used to feed cattle⁴². Coles has misrepresented the true value of prizes it offered as part of a competition⁴³.

European Union

2.36 A number of EU Member States have engaged in investigations into the supermarket sector, with particular reference to the power by major supermarket chains. In a number of cases national competition laws have been introduced to specifically target the issue of buyer power. A report produced in 2009 on behalf of the 'Agribusiness Accountability Initiative'⁴⁴ summarized existing laws and measures against abuses in the grocery market initiated by various EU state competition authorities. Some of the accounts in the report are as follows.

2.37 Austria has competition law that explicitly incorporates the concept of economic dependency in its definition of a dominant market position, applying to both sides of the market (buyers and sellers). This allows for dealing with "abuse of superior bargaining position" in business to business relations.

2.38 France has prohibitions against selling below the purchasing price as well as laws that limit particular buyer power practices such as extra payments not related to the products and rebates.

2.39 Germany has introduced a number of different laws that address buyer power malpractices by supermarkets resulting from superior bargaining power without having to prove harm to the consumer.

2.40 Hungary was proposing to fine supermarket and hypermarket chains if they demonstrate unfair practices against suppliers, unless the chains agree to sign a bilateral agreement on "well-intentioned business practices" and deal with suppliers in a "conscientious and professional" manner.

⁴¹ Op Cit *Inquiry into the Competitiveness of Retail Prices for Standard Groceries*, Chapter 14.5.5.

⁴² ACCC, 'Federal Court declares Woolworths beef advertising false and misleading', media release, 21 August 2002.

⁴³ ACCC, 'Coles corrects Dollar Dazzlers Competition', media release, 16 November 1999.

⁴⁴ *The Abuse of Supermarket Buyer Power in the EU Food Retail Sector: Preliminary Survey of Evidence*. Myriam Vander Stichele, SOMO & Bob Young, Europe Economics. On behalf of Agribusiness Accountability Initiative Amsterdam, March 2009.

2.41 Italy has law prohibiting the imposition of unfair prices and exploitation of “economic dependence” which can deal with abuse of dominant bargaining position.

2.42 Latvia has laws that include a new concept of abuse of dominant position in retail markets over suppliers, with detailed descriptions of dominance. For example, applying or forcing unfair or unreasonable conditions in respect of return of goods; payments in respect of placement of goods in retail premises; payments in order to enter into a contract; and payment settlement deadlines.

2.43 Portuguese law includes prohibitions against abusing a state of ‘economic dependency’.

2.44 Slovakia has law on inadequate conditions in commercial relations, which targets abuses of buyer power and limits extra payments by suppliers to individual retailers.

2.45 The above initiatives have been made in the light of a broad range of concerns expressed with business to business conduct, which have also been alleged to differing degrees in Hong Kong⁴⁵. For example, the types of conduct complained of have included:

- (i) having to pay fees to be put on a list of suppliers;
- (ii) threats of de-listing when suppliers refuse to reduce prices or make other payments and concessions;
- (iii) slotting fees to gain access to shelf space; demanding extra or unforeseen discounts or payments from suppliers for marketing, store openings or remodelling new packaging, and retailer initiated promotions;
- (iv) demanding retrospective payments, discounts, and after-sale rebates;
- (v) compensation for profit margins being less than expected;
- (vi) return of unsold goods to the supplier at the supplier’s expense, including fresh produce that cannot be resold;
- (vii) retrospective changes to agreed terms;
- (viii) forecasting errors borne by supplier; and
- (ix) requiring brand owners to divulge development intentions so that retailers can pass them on to their own brand suppliers.

⁴⁵ The trade practices allegations in Hong Kong will be discussed in Chapter 5.

2.46 Given the concerns with and the business practices in the sector, the EU Commission formed the 'High Level Group on the Competitiveness of the Agro-Food Industry', which produced a report in 2008 making a number of recommendations in the sector⁴⁶. The implementation of the recommendations is currently being overseen by the EU 'High Level Forum for a Better Functioning Food Supply Chain', which includes an expert group focused on business to business contractual relationships. Within the expert group, the trade and business associations representing each stage of the supply chain produced a document in November 2011 entitled *Vertical Relationships in the Food Supply Chain: Principles of Good Practice*.

2.47 The CI Report referred to earlier noted⁴⁷ that these principles could form the basis of a Code of Conduct or a standard to be applied to companies within food supply chains selling into the EU. The CI Report also noted that a survey by the British Institute of International and Comparative Law (BIICL)⁴⁸ on models of enforcement for relations in the food supply chain in Europe illustrated not only how widely buyer power issues are recognised across the EU but how, despite different approaches, authorities have struggled to put in place effective remedies.

North America

2.48 The types of conduct complained of in the EU and Australian grocery sectors are also found in North America. The approach taken by relevant competition authorities, i.e., the US Federal Trade Commission, and the Canadian Competition Bureau has been to examine the complaints within the context of breaches of general antitrust law.

2.49 For example, the Canadian Competition Bureau produces a guideline on its approach to administering the abuse of dominance provisions in the Canadian *Competition Act* and has also produced a separate guideline on the abuse of dominance provisions as applied to the grocery sector⁴⁹. While the guideline discusses some of the issues found in the grocery sector, as discussed above in the EU and Australia, the guideline does not put forward any special remedies towards the problems found in the sector. For example, there are no targeted remedies related to moderating buyer power, such as an industry code with dispute mediation.

2.50 Likewise, the US Federal Trade Commission (FTC) applies general competition law to the problems of the sector. In particular, the *Robinson-Patman Act* is the common platform under which complaints of unfair buyer conduct are examined. This law prohibits price discrimination, i.e. it requires sellers to sell to everyone at the same price, and buyers with the

⁴⁶ http://ec.europa.eu/enterprise/sectors/food/files/high_level_group_2008/documents_hlg/final_recommendations_hlg_17_03_09_en.pdf.

⁴⁷ *Op Cit The Relationship Between Supermarkets and Suppliers – What are the implications for consumers? Page 20.*

⁴⁸ *Models of Enforcement in Europe for Relations in the Food Supply Chain*, Justine Stefanelli, Phillip Marsden, BIICL, 2012.

⁴⁹ <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/01642.html>.

requisite knowledge to buy from a particular seller at the same price as everyone else.

2.51 However, the US Supreme Court has regularly stated that the Robinson-Patman Act must be interpreted consistently within the broader policies of the US antitrust laws. It has warned against interpretations of the law which extend beyond the prohibitions and help give rise to a price uniformity and rigidity in open conflict with the purposes of other antitrust legislation. The FTC's position therefore is that the interpretation and application of the Robinson-Patman Act should be consistent with the interpretation and application of the other antitrust laws whenever possible. This has resulted in a situation where the number of Robinson-Patman cases brought by the FTC declined from about 100 formal investigations and 30 complaints per year in the mid 1960s to virtually none today⁵⁰.

2.52 The broad based antitrust law approach to issues in the grocery sector therefore has its problems. The CI Report noted earlier has commented that *“Modern economic thinking is that the (Robinson-Patman) Act has largely failed. A buyer power symposium held in Oxford on May 15th 2012 took the view that a European version of Robinson-Patman would deliver no benefit whatsoever. (Institute of European and Comparative Law, Oxford University, Conference on Buyer Power in Competition Law, May 15 2012)”*⁵¹.

2.53 A clear distinction can therefore be drawn between the approaches taken in Australia & EU countries and North America (US and Canada) with regard to, firstly, concerns about unfair trading practices in the form of imbalances in bargaining power of contracting parties, and secondly, concerns with potential breaches of competition law, particularly the abuse of market power and anticompetitive vertical or horizontal conduct.

2.54 The approach taken in North America is to examine complaints in the sector only within the context of breaches of general competition law. In the EU on the other hand (and to some extent in Australia) a more interventionist approach has been considered which attempts to find some administrative solution to ‘unfair’ practices as distinct from clear breaches of competition law.

Administrative Measures Taken by Other Countries

2.55 In the UK, for example, the UKCC proposed to use administrative measures to tackle “exploitation abuse”. For example, excessive pricing or substantial market power that is not “predatory abuse”,⁵² or “exclusion abuse” usually dealt with under competition law provisions. The UKCC suggested strengthening the provisions of the previously established *Supermarkets Code*

⁵⁰ Michael R. Baye, Director Bureau of Economics Federal Trade Commission ‘*Prepared Remarks before The Economics and Federal Civil Enforcement Committees of the American Bar Association’s Antitrust Section*’ October 17, 2007.

⁵¹ *Op Cit The Relationship Between Supermarkets and Suppliers – What are the implications for consumers? Page 21.*

⁵² These two kinds of abuses are explicitly stated in section 21(2)(a) & section 21(2) (b) of the Competition Ordinance whereas there is no explicit mention about the exploitation abuse in the Second Conduct Rule.

of Practice and broadening its application such that more grocery retailers would be required to abide by its terms. Importantly, the UKCC also sought to have legally binding commitments from grocery retailers to establish a body to oversee the revised Code.

2.56 In Australia, following a Parliamentary review of problems in food distribution in 1999, the Australian Government (not the ACCC) introduced a *Produce and Grocery Industry Ombudsman (PGIO) Service*, which manages and oversees a panel of suitably qualified mediators who deliver mediation services for disputes in accordance with the Produce and Grocery Industry Code of Conduct⁵³.

2.57 The objects of the Australian Code are to promote “fair and equitable trading practices” and encourage “fair play and open communication” between industry participants. The service has the power to accept, refuse or dismiss the referral of any dispute from an industry participant, excluding consumers, provided that the industry participants have a vertical relationship with one another and the dispute relates to produce within the meaning of the Code. Code signatories include all the major industry retail, wholesale and producer associations, and the two major supermarket chains.

2.58 The approach in Australia and in the UK therefore is not only to use competition law (specifically the misuse of market power/abuse of dominance provisions) but also provide for an administrative mechanism to resolve buyer/seller disputes to address the imbalance of bargaining power.

2.59 As far as administrative mechanisms are concerned, the Australian approach is more geared to fair trade, addressing the imbalance of bargaining power between suppliers (especially primary producers) and retailers within the sector. The grocery sector Ombudsman service, as far as can be ascertained, is working to the satisfaction of industry participants.

2.60 The Australian grocery/supermarket sector has similar concentration levels as found in Hong Kong (two dominant retailer chains) and similar complaints with regard to buyer power. As such, the Australian approach can serve as useful reference value to Hong Kong. Application of the Australian approach to the Hong Kong sector is further explored in Chapter 7.

⁵³ Produce and Grocery Industry Ombudsman, <http://www.produceandgrocerycode.com.au/index.html>.

Chapter 3 Defining the Relevant Market

3.1 In its 2003 Report on “Competition in the Foodstuff and Household Necessities Retailing Sector”, the Council adopted the concept of “one-stop shopping” as the essential starting point for its competition analysis in the sector; and identified supermarkets in particular as worthy subjects for analysis in determining market power. It defined a market for packaged foodstuff and household necessities where supermarkets compete with other retail outlets, such as convenience stores, grocery stores, and specialty stores. The concept of “one stop shopping” and the perception of market power held by supermarkets was an accepted part of competition analysis undertaken by authorities in similar advanced economies.

3.2 This approach to “defining” the relevant market assumed that consumers typically choose, without reservation, between supermarket chains and other types of groceries retailers offering the same “one stop shopping” services. This chapter examines the current relevance of that approach in terms of how Hong Kong consumers now choose amongst grocery retail services, with regard to their proximity, their product range, and the quality of the services offered.

Categories of Grocery Retailers

3.3 As at December 2011, an estimated \$79.3 billion of grocery annual sales⁵⁴ were made through nearly 2100 grocery outlets and convenience stores in Hong Kong⁵⁵. Grocery stores can be classified in the following six categories:

3.4 *Large grocery retailers* have operations throughout all areas in Hong Kong. These retailers carry a full-range of grocery products and have an integrated purchase department that deals with grocery suppliers based on their standard term supply agreements. There are currently 4 large grocery retailers in Hong Kong, namely the Group, Dairy Farm Group, China Resource Group and Jusco/AEON Group. Large grocery retailers may operate stores in multiple store size categories from 150 to 5000 sq meters. Some carry their own-label goods as well as branded products. The two largest groups also operate under different brands targeting different groups of consumers.

3.5 *Mid-sized grocery stores* are full-range grocery stores between 40 sq metres to less than 1000 sq metres. Most of these retailers are single outlet operators that order goods directly from grocery suppliers. There were around 69 single operator grocery stores in Hong Kong at 2011, which increased

⁵⁴ The figure only counts the figures from sales of outlets of “Food, alcoholic drinks and tobacco” and sales of all supermarkets – ‘Report on Survey of Wholesale, Retail and Import and Export Trades, Restaurants and Hotels’, December 2011, Census and Statistics Department.

⁵⁴ There were 66 single outlet supermarket operators in 2001.

⁵⁵ Table E006: Number of establishments, persons engaged and vacancies (other than those in the Civil Service) in the retail trade analysed by type of retail outlet of Report on Survey of Wholesale, Retail and Import and Export Trades, Restaurants and Hotels, December 2011, Census and Statistics Department.

slightly⁵⁶ over the last ten years. They are mostly located in rural areas with few employees serving in the shop (average number of employee is 2.1). From 2001 – 2011, the average floor area of this kind of shop decreased from 120 sq meters to 69 sq metres. The floor size of these shops limits the product range that can be offered and therefore the extent of rivalry with large grocery retailers.

3.6 *Limited Assortment Discounters* (LADs) carry a defined range of grocery products and base their retail offer on selling these products at very competitive prices. The best known brands are Dah Chong Hong, Kai Bo Food Supermarket, Kai Hing Supermarket and PrizeMart. They carry in the region of several hundred SKUs (store keeping units) with a floor area ranging from 100 to 1000 sq metres. Most of these operate in middle-income and low-income family residential areas.

3.7 *Convenience stores* are characterised by their around the clock operation, and are seen to be generally less competitive on prices and product choices as compared to supermarkets. They are seen as relying on their convenience attributes where goods are normally bought for immediate, or near immediate consumption. Whether convenience stores and the other types of grocery stores noted above compete directly with each other is debatable. There are more than 1300 convenience stores in Hong Kong. The two largest being 7-Eleven (which, along with Wellcome, is owned by Dairy Farm) with 914 outlets, and Circle K with 328 outlets in 2013. Other branded stores have less than 5% of market share.

3.8 *Other specialized retailers*, These specialize by generally carrying a limited range of grocery products. *Specialist grocery retailers* primarily sell an individual grocery product category; for example, frozen food, bakeries, wet market operators (butchers, fishmongers, greengrocers) and health food shops.

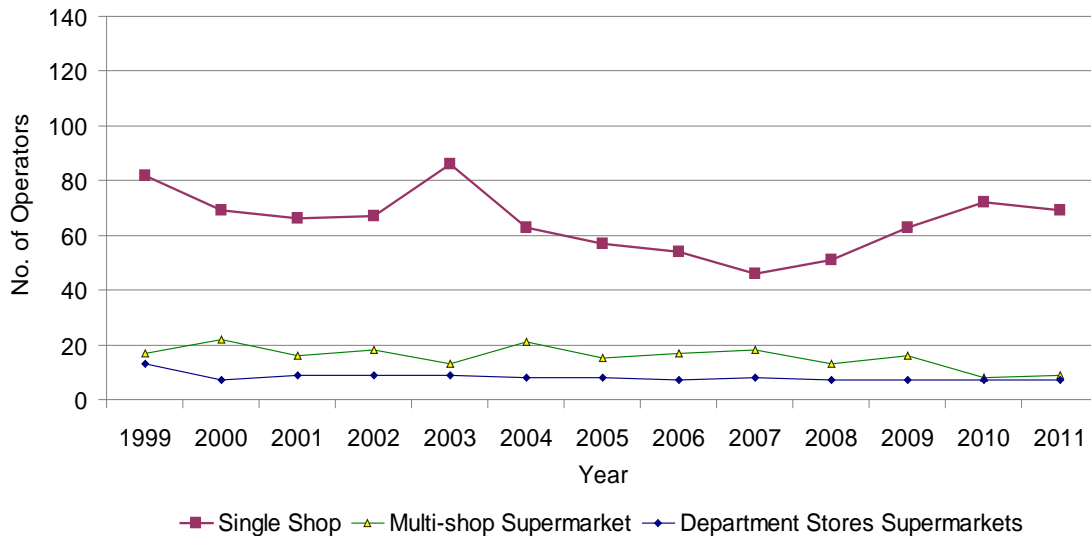
Number of Operators and Retail Outlets

3.9 As noted in the sales statistics for December 2011, whilst the supermarket category constitutes a very small number (77 establishments) of Hong Kong's retail establishment (total number of retail establishments = 53,094) , its share in terms of retail sales is significant (about 8.9% of total sales in 2011)

3.10 An examination of the number of supermarket operators and the number of retail outlets each operator has can add to the picture of market presence, leading to a clearer understanding of competition in the market place.

⁵⁶ There were 66 single outlet supermarket operators in 2001.

Figure 3.1: Number of Supermarket Operators from 1999 to 2011, (Single Shop, Multi-shop & Department Stores Supermarket)



3.11 The Council's 2003 study noted that in 1996 there were about 132 supermarket operators⁵⁷, of which 9 operators had more than one store. In comparison, the Year 2001 statistics revealed a figure of 82 supermarket operators, with 16 operators having more than one outlet and 66 operators being single shop operators - a substantial decline of small operators by approximately 46% within 5 years.

3.12 Since then, there has been a decrease of 5% in total number of supermarket operators over the last 10 years, whereas the number of supermarkets with few outlets stabilized to around 69 in the same period⁵⁸. In addition, the number of department stores with supermarkets also dropped significantly from 13 to 7 from 1999 to 2011.

3.13 Most supermarket operators are single shop operators with very little floor space in comparison with the floor space of larger operators.⁵⁹ Moreover, supermarket operators with larger floor space have a significantly higher percentage of employees, compared with single shop operators. Accordingly, it is difficult for single shop supermarkets to provide substantial competitive pressure to the two large supermarket chains because of limits on their product range (due to small floor space) and/or customer service (due to smaller numbers of employees).

⁵⁷ Notes: Supermarket operators include both conventional supermarkets and convenience stores under the definition used by Census and Statistics Department.

⁵⁸ Source: Census and Statistics Department, Report on Annual Survey of Wholesale, Retail and Import and Export Trades, Restaurants and Hotels, 1996 – 2012.

⁵⁹ For example, the largest superstore of Park n Shop in Hong Kong has a floor area of 72,000 square feet and sells over 20,000 store keep units in Metro City Tseng Kwan O in 2004. The largest Wellcome superstore has a floor area of 54,000 square feet in 2001.

Table 3.1: Number of Chain Retail Outlets⁶⁰

Types of Grocery Outlets (defined in Para 3.10-3.15)	Retail Chain	No. of Outlets in 2003	No. of Outlets in 2011	No. of Outlets in 2013 ⁶¹
Large Supermarket Chain ⁶² + Mid-sized Grocery Stores	Wellcome*	242	261	280
	Market Place by Jasons*	No Data	15	23
	ThreeSixty*	No Data	2	2
	PARKnSHOP**	211	196	210
	International**	25	25	22
	Taste**	3	10	10
	Fusion**	No Data	7	12
	Gourmet**	No Data	1	1
	Great**	No Data	1	1
	SU-PA-DE-PA**	No Data	No Data	1
	City'super	1	4	4
	CR Vanguard	79	103	95
	JUSCO Supermarket	4	5 (7)	9
	YATA Supermarket	2	2 (3)	3
Subtotal =		567	632	673
Limited Assortment Discounters (212 outlets)	DCH Food Mart	43	41	37
	DCH Food Mart Deluxe	No Data	42	48
	Kai Bo Food Supermarket	No Data	86	86
	Kai Hing Supermarket	No Data	9	8
	PrizeMart	No Data	(18)	21
	PARKnSHOP Frozen**	No Data	No data	12
Subtotal =		43	178	212
Convenience store (1326 outlets)	7-Eleven***	485	931	914
	Circle-K	176	325	328
	Van GO	No Data	63	80
	EXPRESS**	No Data	No Data	4
Subtotal =		661	1319	1322

⁶⁰ Source: Grocery Trade Magazine 2011-2012; Websites of Wellcome, Market Place by Jasons, Oliver's The Delicatessen, Three Sixty, PARKnSHOP, CRC Vanguard, City'super, DCH Food Mart, Kai Bo Food Supermarket, Prize Mart, 7-Elven & Circle-K.

⁶¹ The number of grocery outlets are updated to the end of June 2013.

⁶² Notes: * Owned by Dairy Farm Group; ** Owned by A.S. Watson Group; *** Partly owned by Dairy Farm Group and partly operated by franchise.

Relevant Market

3.14 In the Government's submission on Guidelines on Market Definition to the Bills Committee of the Legislative Council⁶³, when the Competition Bill was discussed, it was stated that

"...A market definition should normally contain two dimensions: the product market and the geographic market. It is often practical to define the relevant product market first and then to define the relevant geographic market. ...In order to establish which products are "close enough" substitutes to be in the relevant market, a conceptual approach known as the hypothetical monopolist test is used."

3.15 In the context of grocery retailing, "demand-side substitution" occurs when consumers switch either all or part of their grocery expenditure to another store. This might be in response to a change in price, but may also be in response to a change in one or more of the other non-price aspects on which stores compete, such as product range, quality or service. This may also depend on how far Hong Kong consumers are willing to travel or undertake research in searching for competing grocery products and whether they would travel across different geographic areas for grocery shopping.

3.16 "Supply-side substitution" occurs when a price increase prompts other companies to start supplying, at short notice, an effective substitute to the product in question. Supply-side substitution will typically come from companies with existing facilities, providing similar products and/or operating in adjacent areas. There are several obstacles that a retailer would need to overcome if it were to start supplying competing groceries at short notice. These obstacles might have both a product and a geographic dimension.

One-stop Shopping

3.17 There are many different possible starting points in defining the relevant market through assessing substitutes. One-stop shopping is a highly developed form of retailing in advanced economies. Typically it refers to supermarkets which provide a convenient form of shopping for consumers where a complete range of foodstuffs and household necessities is readily available for purchase without the necessity of visiting other retail outlets.

3.18 The UK Competition Commission and UK Office of Fair Trading both identified two interrelated markets for the supply of groceries to final consumers in the United Kingdom, based on shop floor size:

- (i) A retail market for "one-stop shopping", where shop floor size is over 15,000 square feet; and
- (ii) A retail market for "secondary shopping" (including convenience shopping), where shop floor size is less than 3,000 square feet.

⁶³ <http://www.legco.gov.hk/yr09-10/english/bc/bc12/papers/bc120531cb1-2336-1-e.pdf>.

3.19 One-stop shopping is defined as shopping for the bulk of a household's periodical grocery needs, carried out in a single trip and under one roof. Other forms of shopping, characterised as "secondary shopping", such as in convenience stores was typically distinguished by a lower average basket spend.

3.20 Given that one of the questions at hand could be the market power that one stop shopping outlets might have over other specialty outlets, or the market power certain one stop shopping outlets might have over other one stop outlets, the process should start with assessing the shopping behaviour of households in doing their groceries shopping.

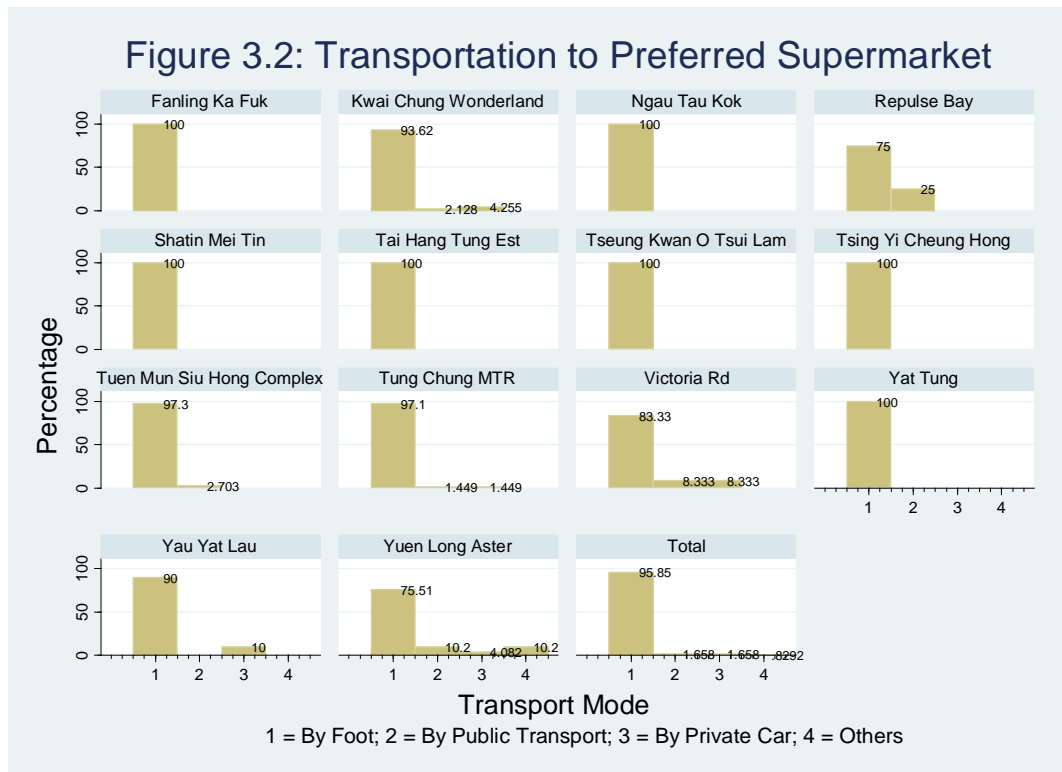
3.21 The findings of a survey of household shopping behaviour by Planning Department in 2005⁶⁴, are instructive in this regard, particularly in identifying the geographic dimensions of the relevant market. The Department found that

- (i) *Most households (95.2%) normally purchased food in their district of residence, with 68.7% patronizing food stores near home (i.e. within 10 minutes' walking distance) and 26.5% away from home but within the district of residence*
- (ii) *97.4% of households normally purchased general household goods from stores inside their district of residence, with 76.6% patronizing stores near home (i.e. within 10 minutes' walking distance) and 20.8% away from home but within the district of residence.*

3.22 The Council has conducted an "Exit Survey" with a similar object of collecting consumers' perspectives regarding the availability of alternative choices for grocery shopping in a sampled catchment area⁶⁵. It was found that at least 75% of respondents travel to their preferred outlet by foot in all sampled areas. In some areas the proportion of households travelling by foot reached 100%. These results support the findings of the survey by the Planning Department. In terms of defining the relevant market, it is reasonable therefore that a 10 minute walking distance or 500 meters to a targeted store could be assumed to be the geographic boundary of the relevant market.

⁶⁴ Para 7-8, "Executive Summary of Shopping Survey (Household Survey)", Planning Department 2005.

⁶⁵ The detail of the sampling and methodology of the "Exit Survey" was illustrated in Annex 3.1.



Product or Service Market

3.23 In analysing the product dimension of the relevant market for grocery retailing, the Council has re-examined the concept of “one-stop shopping” in its competition analysis as a possible product dimension. It is understood that there are three non-price attributes for grocery market operators to compete in its relevant market: (a) the categories of goods supplied; (b) the number of goods in each category supplied; or (c) the quality level of good supplied.

3.24 There is limited supply of ‘large store space’ in Hong Kong. Retailers are generally constrained with respect to store space and shelving space, thereby limiting the choices of the range and number of categories of goods they can offer. Most Hong Kong retailers need to choose between limiting the number of categories supplied or the number of goods available in each category, or the quality range supplied.

3.25 Should a retailer, for example, want to adjust its product range, such as introducing other categories or quality levels it would need to not only establish new relationships with new suppliers, but undertake an expansion of its store. This is likely to be too costly with the result that supply-side substitution for operators specializing in certain categories with limited shelf and floor space is not likely to take place.

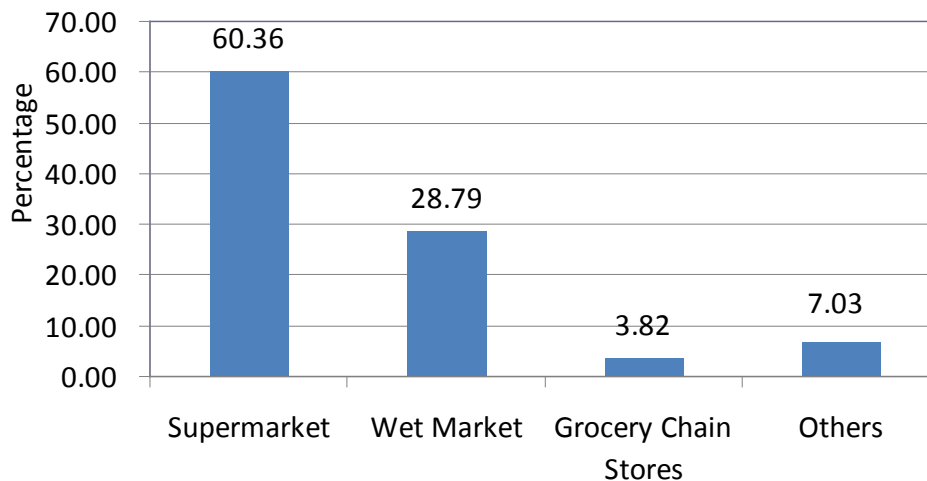
3.26 A study by the Planning Department in 1997 found that 58% of the sampled Hong Kong population chose supermarkets as their primary place for

grocery shopping, including food and household necessities⁶⁶. Planning Department updated their finding by a survey in 2005. According to information from the Planning Department survey, it was found that

- (i) 74.0% normally purchased food from "(wet) markets" and 25.4% from "supermarkets"
- (ii) For those households that normally purchased food from "(wet) markets", the major reasons were "more convenient locations" (42.1%), "fresher food" (36.8%), "wider variety of food" (30.6%) and "lower prices" (23.1%).
- (iii) For those households that normally purchased food from "supermarkets", the two major reasons were "wider variety of food" (53.0%) and "more convenient locations" (50.8%).

3.27 In the Council's "Exit Survey", households were asked which type of store they most frequently visited to purchase food, in addition to the supermarket they were visiting during the interview. Of those interviewed, 40% of respondents indicated they treated the following outlets as substitutes compared to supermarkets - wet markets (28.8%), grocery chain stores (3.8%) others (7.0%).

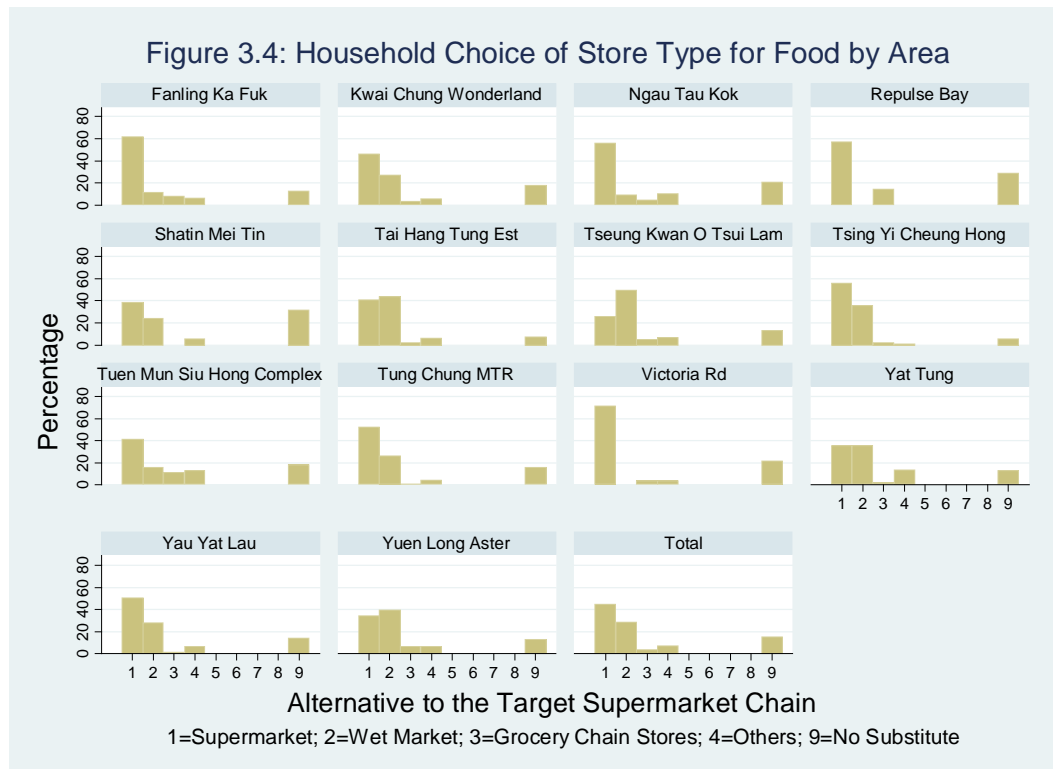
Figure 3.3: Supermarkets and Wet Markets Are the Top Two Choices of Store Type for Food



3.28 It is noteworthy that the respondents choosing wet markets as an alternative to supermarkets were quite different across different areas. It was found that there were only five out of 14 sampled areas where more than 30%

⁶⁶ Roger Tym and Partners, *Study on Shopping Habits and Revision of Hong Kong Planning Standards and Guidelines*, Chapter 6, Final Report February 1998 commissioned by the Planning Department.

of respondents chose wet markets and other non one-stop shopping outlets as a substitute for the supermarket. This implies that there is a strong geographical factor to be considered in addition to the product type factor in defining the boundary of the relevant market.

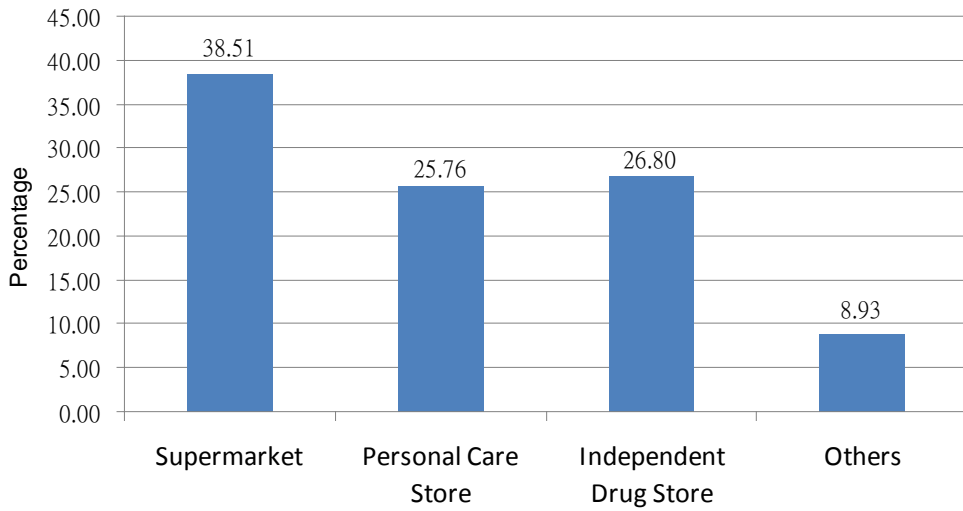


3.29 With respect to general household goods, Planning Department found in the same survey that there was a strong consumer preference for *supermarkets (80%) and ordinary drug stores (14.5%) over other forms of retailing for general household goods*. The report stated that

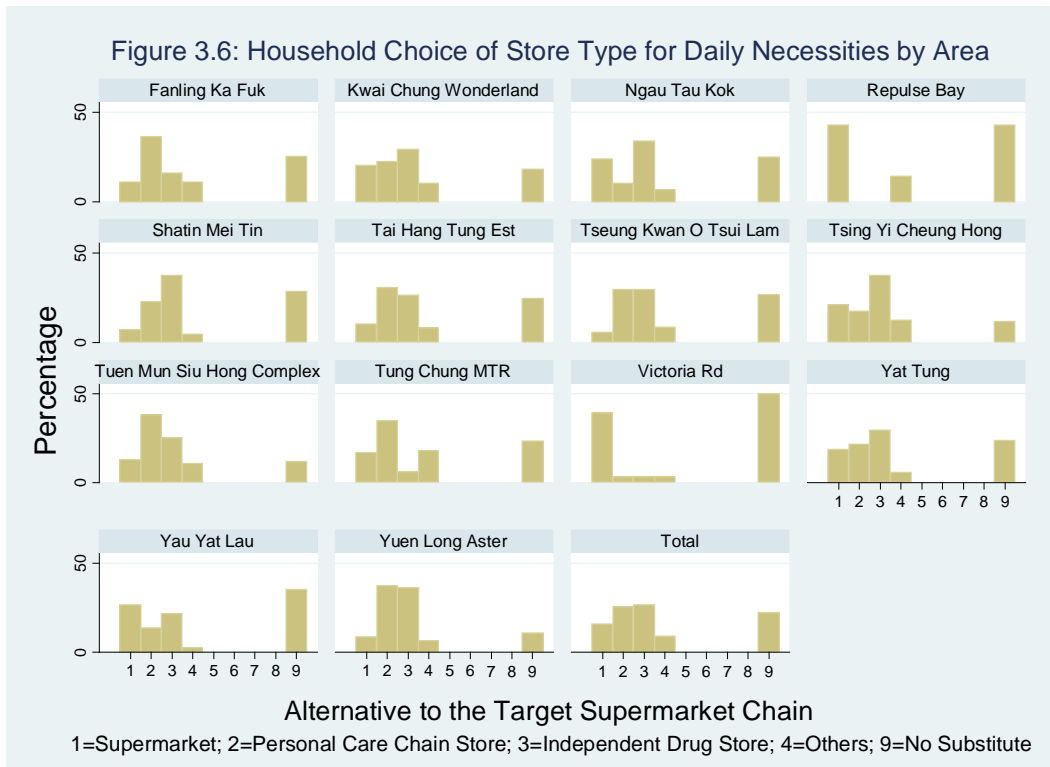
- (i) *For those households that normally purchased general household goods from "supermarkets", the major reasons were "wider variety of goods" (60.9%) and "more convenient locations" (49.0%), followed by "lower prices" (12.6%).*
- (ii) *For those households that normally purchased general household goods from "drug stores", the dominant reason was "lower prices" (75.9%), followed by "more convenient locations" (27.9%) and "wider variety of goods" (8.4%).*

3.30 The Council's "Exit Survey" indicated that many households (over 50% of households in the sample) treated personal care chain stores or independent drug stores as close substitutes for supermarkets for retail services of daily necessities. This finding was not quite in line with the results of the survey by Planning Department which found only 16% of households choose supermarkets for household necessities.

Figure 3.5: Supermarkets, Personal Care Chain Stores and Independent Drug Stores Are the Top Choices of Store Type for Household Necessities



3.31 Moreover only five areas existed (out of 14 areas sampled) where less than 50% of respondents did not choose personal care chain stores or independent drug stores as a substitute for supermarkets in purchasing daily necessities. As a result, in considering the product and geographic dimensions of the market for household necessities it is very difficult to exclude personal care chain stores and drug stores from the available one stop shopping substitutes, regardless of their location.



SNNIP Test

3.32 During Legislative Council discussions on the Guidelines referred to in the proposed Competition Bill, the SNNIP test, i.e. measuring the effects on demand and supply of a small but significant non-transitory increase in price, was adopted as a relevant tool for market definition, and was explained as follows:

“The (SNNIP) test starts by considering a hypothetical monopolist of the focal product (i.e. normally the product under investigation) which operates in a focal area (i.e. normally the area under investigation in which the focal product is sold). The next question will be whether it would be profitable for the hypothetical monopolist to sustain the price of the focal product a small but significant amount (e.g. 5 to 10 per cent) above competitive levels. Usually, the current pricing levels are assumed to represent the competitive levels and are used as the starting point.

If the answer to this question is 'yes', the test is complete. The product and area under the hypothetical monopolist's control is usually the relevant market. If the answer to this question is 'no', this is typically because a sufficiently large number of customers would switch some of their purchases to other substitute products (or areas). In this case, it will be assumed further that the hypothetical monopolist controls both the focal product and its closest substitute. The test will then be repeated, but this time in relation to the larger set of products (or areas) under the hypothetical monopolist's control.

As before, the question to be asked is whether it would be profitable to sustain prices at 5 to 10 per cent above competitive levels. If so, the test is complete. The relevant market is usually the focal product and its closest substitute. If not, we assume the hypothetical monopolist also controls the second closest substitute to the focal product and repeat the process once more. The product group (or areas) will continue to be expanded in this way (i.e. by adding the next best substitute) until a group of products (or areas) is found for which it is profitable for the hypothetical monopolist to sustain prices 5 to 10 per cent above competitive levels.”

3.33 In the Council's “Exit Survey” a quasi-SSNIP test question was posed to interviewees to determine how they would alter their shopping pattern if the supermarket they visited had 10% higher than average prices for food products and daily necessities. 57% of respondents chose either no change in their shopping pattern or only a slight decrease in the number of visits to the supermarket. Only 32% of respondents said they would increase their visits to alternative outlets, including other supermarkets, wet markets, grocery chain stores, personal care chain stores and independent drug stores (thereby suggesting those outlets were within the relevant market as far as they were concerned). The remainder did not specify their choices.

Two Separate Relevant Grocery Markets

3.34 The Council assumes that purchases in convenience stores would typically be different to those in other types of grocery outlets, including personal care chain stores, supermarket chain stores, grocery chain stores and individual drug stores. Shopping in convenience stores is not 'one-stop shopping' in the normal sense of the term and should therefore be excluded in the relevant market for grocery shopping in Hong Kong for the purposes of this study.

3.35 In considering the concept of "one-stop shopping" in Hong Kong, the findings of the Council's "Exit Survey" and the Planning Department Survey provide useful insights into the definition of the relevant market based on the type of grocery product. The findings could be seen to raise doubts as to whether the Council should apply the concept of "one-stop shopping" to shopping for both pre-packaged food and household daily necessities.

3.36 The findings in the "Exit Survey" indicated a very distinct pattern of choice between shopping for pre-packaged food and shopping for household necessities across sampled areas. With respect to shopping for pre-packaged food, households in the majority of sampled areas did not treat supermarkets and wet market as close substitutes. However, they did indicate that supermarkets, drug stores and personal care chain stores were considered close substitutes when purchasing household daily necessities⁶⁷. This pattern suggests that bundling demand for pre-packaged food and household necessities into the one market would not be appropriate in Hong Kong's current circumstances.

3.37 With regard to household daily necessities, considering the growth of the drug stores and personal care chain stores and the supporting evidence from the Council's "Exit survey", it would appear that the boundaries of the relevant market should include competition from personal care and independent drug stores.

3.38 In view of new information that has been found, it is preferable therefore to treat shopping for food (pre-packaged and fresh) and household necessities as two separate relevant markets instead of following the "one-stop shopping" concept in our previous study.

3.39 A market definition approach is therefore used, in which there is one market identified for shopping for fresh produce and packaged food in supermarkets and wet markets; and another market for shopping for household products and necessities in supermarkets and other retail outlets, such as personal care chain stores and independent drug stores. It appears therefore that supermarket chains compete with different types of shops in the

⁶⁷ It should be noted that no definitive study has been done on the supply and demand characteristics for fresh produce and pre-packaged food that would clearly justify excluding wet markets and other grocery outlets from the relevant market that would include purchases from supermarkets.

market for food (pre-packaged and fresh) and the market for household products and necessities. Nevertheless, the degree of market power in these two separate markets will depend on the availability of rival stores within a geographical dimension. This will be further discussed in Chapters 4 & 5.

3.40 Notwithstanding the findings of the Council's survey on consumer choices in the "Exit Survey" and thereby market definition, it is also necessary to assess the ability of the two large supermarket chains to act "how they want" which is a clear indication whether there is market power. Market power is basically a firm's ability to manipulate price by influencing an item's supply or demand, or both. In other words, whether they are price makers rather than price takers.

3.41 It is therefore necessary to keep in mind that the definition of a market is not an end in itself, but a part of the process of identifying market power⁶⁸. In other words the main point is to examine competitive effects of the conduct or transaction under examination not simply to "identify a market". It is but one necessary step in the overall process of antitrust analysis. Moreover, identifying the power that a firm has in the defined market to "give less and charge more" will ultimately resolve the question as to whether there is a competition problem in relation to particular conduct, within the defined market's various product and geographic dimensions.

⁶⁸ FTC Commissioner Richard Blumenthal, "Why Bother? On Market Definition under the Merger Guidelines" presented in a FTC/DOJ Merger Enforcement Workshop on Market Definition, argued that *"Is market definition an input to competitive effects or an output? The answer is probably "Both" or "Neither" – it's a case of simultaneous determination."* 2004.

Annex 3.1 Methodology of “Exit Survey”

1. The Exit Survey was a follow-up study of the Price-Quality-Range-Service Study of Supermarket Chains (details described in Annex 5.1) the objective of which was to collect consumers’ perspectives regarding the availability of alternative choices in a sampled catchment area.
2. Twelve stores from 8 broad regions of Hong Kong (See Annex 5.1 Para 9) were selected from the 43 Type I or Type II supermarkets (see definition in Section Annex 5.1 Para 7) previously sampled in the PQR Study of Supermarket Brands (see Chapter 5). An additional store “Taste - Citygate (東薈城)” was also included in the Exit Survey. For each store, opinions of eligible respondents on the price, quality and range of the target supermarket against their alternative choices were obtained.
3. To obtain sample data representing the overall market status for competition, the Consumer Council commissioned a market research company to carry out a data collection service on chain supermarkets across different areas of Hong Kong from 8th June to 1st July 2012. A total of 120 supermarket branches from major supermarket chains (ASWatsons, Dairy Farm Group and other major groups such as CR Vanguard, UNY(HK), JUSCO, SOGO and YATA) were sampled. For each sampled store, stock status, prices and availability of promotional discounts for multiple purchases for a total of 100 pre-listed items were checked. In addition, store characteristics, including approximate store size, number of cashiers, accessibility facilities, etc., were obtained.
4. The sampling frame of the Exit Survey only comprised 43 stores across 8 regions which fulfilled the following criteria:
 - (i) They were among the 120 supermarket stores sampled in the PQR Study of Supermarket Brands.
 - (ii) They were classified as either Type I⁶⁹ or Type II⁷⁰ in terms of competition (refer to Annex 5.1 Para. 7 for detailed definition).
 - (iii) As some stores were located in large-scale residential areas managed by estate management companies, the exit survey method was not feasible. Therefore, three stores, including “PARKnSHOP Superstore - Heng Fa Cheun(杏花邨)”, “Wellcome - Richwood Park (嘉豐花園)” and “International - Hong Lok Yuen (康樂園)” were excluded from the sampling frame.
5. Two supermarkets per broad region, including one (1) Type I supermarket

⁶⁹ “Type I” store refers to “Isolated” store, i.e. without competitors, whether comparable or non-comparable, within a 500-meter catchment area.

⁷⁰ “Type II” store refers to supermarkets “with non-comparable competition”, i.e. having only non-comparable competitors but no comparable competitors within a 500-meter catchment area.

and one (1) Type II supermarket, were sampled from each of the 8 broad regions. In the case of no suitable Type I or Type II store in the region, no replacement was made. Based on this criteria no supermarket store was sampled from the HKI-E region. A total of 12 stores from 7 regions were sampled as a result.

6. Further remarks on the sampling of stores are noted below:
 - (i) The store “Market Place by Jasons - Repulse Bay Road (淺水灣道)” was situated in a shopping mall, and customers usually left the shopping mall by car or taxi. This made fieldwork extremely difficult in terms of approaching potential respondents. Upon reviewing the situation after the first day of fieldwork, the store was replaced by “Wellcome - Scenic Villa (美景臺)”.
 - (ii) The store “Wellcome - Yau Yat Chuen (又一村)” was erroneously classified under Kowloon City District and hence KLN-E Broad Region during database preparation. While rectification was carried out afterwards and the store was regrouped under Sham Shui Po District and KLN-W region, it resulted in no sampled Type I supermarket for KLN-E.
 - (iii) On top of the 12 stores sampled above, two additional stores, “Taste - Citygate (東薈城)” and “Yat Tung Estate”, were also sampled upon request by the Consumer Council.
7. A total of 150 eligible respondents for each sampled store were targeted. The eligible respondents were defined as persons who were living or working within a 500 meter catchment area of the sampled supermarket at the time of interview; and had visited the captioned supermarket within the past month.
8. The following areas of investigation were covered in the survey:
 - (i) Screening items (whether living/ working within 500 meter of the sampled store; when last visited the captioned supermarket).
 - (ii) Whether there are alternatives of food products and daily necessities as perceived by respondent; if so, the closest competitor beside the targeted supermarket.
 - (iii) Whether the sampled supermarket or the closest competitor is the main shopping store of the respondent.
 - (iv) Perception of Price, Quality and Range of the sampled supermarket when compared with its closest competitor.
 - (v) Price discrimination – whether special discounts would be offered for residents.

- (vi) Response to price elevation of the sampled supermarket.
 - (vii) Profile of shoppers, including age group, gender, whether they are household shopping decision makers, spending per shopping basket of last visit, and transportation type normally used.
9. A number of fieldwork locations were assigned for each sampled supermarket with the following reasons:
- (i) Given that some supermarkets were located within residential estates, it was not possible to conduct fieldwork directly outside the exits of the supermarkets. In such cases, public location(s) closest to the sampled supermarket would be selected as the site of fieldwork.
 - (ii) The above helped ensure that the respondents approached were not biased towards a particular neighbourhood.
 - (iii) Interviewers shifted among different fieldwork locations every hour to ensure that respondents from different neighbourhood were adequately represented in the sample. Fieldwork was conducted on four days covering two weekends. Within each fieldwork day, fieldwork was conducted during 10am to 8pm.

Chapter 4: Market Power of Grocery Market Retail Players

4.1. A market is taken to be fully competitive where no firm is able to act independently of any other firms competing in that market, or where a firm's behaviour is effectively constrained by the threat of entry from firms outside the market. In this situation no firm should be able to raise and sustain its prices above the competitive level, or act in such a way that affects competition by foreclosing market entry or foreclosing competition.

4.2. In the Government's paper on Guidelines on the Second Conduct Rule to the Bills Committee of the Legislative Council⁷¹, when the Competition Bill was discussed, it was stated that

"Market power arises where an undertaking does not face sufficiently strong competitive pressure and can be thought of as the ability to profitably sustain prices above competitive levels or to restrict output or quality below competitive levels. An undertaking can, in principle, temporarily raise its prices above competitive levels. If an undertaking that faces competition does so, however, it will be unable to do so "profitably" for a sustained period, because customers will switch to other cheaper suppliers, additional suppliers may enter the market, and hence the undertaking will lose sales and become unprofitable. The ability to make decisions on pricing and quality without regard to the reactions of customers and other suppliers is the essence of market power."

4.3. It is understood that firms try to maintain, or seek out market power, so that they are able to remain profitable while charging prices above competitive levels, over a non-transitory period. However, the public concern with firms possessing market power and exercising that power is with the possibility of it limiting output and raising price. Both of these are detrimental to consumer welfare.

4.4. A market participant with market power might also have the ability and incentive to harm the actual process of competition. For example, by engaging in conduct that has the effect of weakening existing competition, raising entry barriers, or slowing innovation. The Second Conduct Rule of the Competition Ordinance forbids a firm with a substantial degree of market power from engaging in any anticompetitive unilateral conduct that has as its object or effect the prevention, restriction or distortion of competition in (the relevant market) in Hong Kong⁷².

4.5. Proof of substantial degree of market power is required to substantiate an allegation of anti-competitive conduct. However, as with competition laws found in other jurisdictions, the Hong Kong Competition Ordinance only prohibits the abuse of a substantial degree of market power. It does not prohibit undertakings from merely having a substantial degree of market power or striving to achieve it through legitimate means. It is important to stress that if

⁷¹ <http://www.legco.gov.hk/yr09-10/english/bc/bc12/papers/bc120531cb1-2336-1-e.pdf>.

⁷² Section 21(1) Competition Ordinance Hong Kong Law Chapter 619.

the alleged conduct has no anti-competitive effect, then it will not merit condemnation regardless of how much market power the undertakings possess.

4.6. Market power is not absolute. It is a matter of degree, and the degree of market power that the particular undertaking in question possesses will depend on its market situation and its business environment. More than one undertaking may have a substantial degree of market power in a relevant market. It is not necessary to demonstrate a market player is a monopoly or has absolute power in a market in order for it to have a substantial degree of market power. In assessing whether an undertaking has a substantial degree of market power, the extent to which there are constraints on that undertaking's ability to profitably sustain prices above competitive levels needs to be considered.

4.7. In this regard two key issues are common to all investigations or research into competition and the abuse of market power. Firstly, there is the definition of the relevant product or service and geographic dimensions in relation to which market power may be found to exist; and secondly the identification of how market power itself has been practiced.

Identifying Market Power

4.8. The idea of relevant product and service markets, in terms of "foodstuffs" versus "household necessities" and "one stop shopping" versus "secondary shopping" has been discussed in Chapter 3. As noted, the Council is of the view that rather than using the "one-stop shopping for foodstuffs and household products and necessities" definition, it should adopt a two market approach: one for "one-stop shopping of food stuffs" and another for "one-stop shopping of household products and necessities" as the relevant markets in this competition study.

4.9. Market power (in some jurisdictions referred to as market dominance) is commonly associated with (amongst other factors) reference to (i) barriers to entry; and (ii) the market share of other parties involved in the relevant market.

4.10. This approach assumes that a market participant will not normally be able to exercise power in a market if it is subject to strong and effective competition from actual or potential rivals.

Barriers to Entry

4.11. Market incumbents at the retail level have less ability to exercise market power against, for example, the interests of suppliers, if there is a constant threat of new entry at the retail level. It is the threat of new entry that places competitive pressure on incumbent retailers to maintain competitive prices, product choices and quality of service and necessitates a receptive attitude towards suppliers.

4.12. The two largest supermarket chains in Hong Kong have a well-established retail and distribution network throughout residential areas of

Hong Kong. In many areas, there is more than one supermarket chain store within a 15 minutes walking distance.

4.13. According to statistics from Census & Statistics Department in 1999 and 2011⁷³, the number of small supermarket operators, with less than two outlets, has substantially declined by 16% over twelve years. Moreover, statistics in 2011 revealed that small supermarket operators only contributed very little floor space, with less than 1%, to the total sector compared to the large operators. For example, the largest superstore in Hong Kong had a floor area of 72,000 square feet (7,600 square meters) and sold over 20,000 product categories. The largest Wellcome superstore in 2001 had a floor area of 54,000 square feet (5,000 square meters).

4.14. Many retail properties in Hong Kong are managed by The Link Real Estate Investment Trust ("The Link REIT"). This was the first real estate investment trust listed in Hong Kong, is currently Asia's largest REIT, and is one of the world's largest retail focused real estate investment trusts in terms of market capitalization. The portfolio consists of properties with an internal floor area of approximately 11 million square feet (more than 1 million square meters) of retail space in purpose built shopping malls. The Council assumes that there is a substantial price advantage when bundling rental arrangements between the largest supermarket chain operators and the Link REIT, than would exist between single shop operators and the Link REIT. Opportunity for new operators to obtain suitable retail space, when attempting to introduce a new supermarket, at costs similar to those experienced by the largest operators, is therefore expected to be limited⁷⁴.

4.15. There have been previous attempts at entry into the supermarket sector in Hong Kong; the most notable being the multinational supermarket chain Carrefour, which began operations in 1996. At its peak, Carrefour operated four outlets, which it described as 'hypermarkets': a 30,000 square feet (2,800 square meters) store on Hong Kong Island, one in Kowloon and two in the New Territories. Despite an aggressive discount marketing strategy which attracted media and public attention, Carrefour closed all its 4 hypermarket outlets only four years later in 2000. Its publicly stated reason was to blame the lack of adequate floor space to effectively develop its hypermarket concept in Hong Kong.

4.16. In the Council's 2003 study it was reported (without revealing names) that the average quarterly selling prices of 127 fast moving consumer goods (FMCG) of the two largest supermarket chains significantly dropped after the entry of a rival supermarket and significantly increased after the exit of that rival. Given that there has not been any significant entry into the supermarket sector since 2000, it is possible, taking the above historical statistical data into account, that the two largest supermarket chains currently face minimal

⁷³ Census and Statistics Department, Report on Annual Survey of Wholesale, Retail and Import and Export Trades, Restaurants and Hotels, 2000 – 2012.

⁷⁴ The Council understands, however, that the HA adopts its leasing arrangement in response to market demands in order to cater for daily necessities of the public housing residents under its managed shopping centres and retail facilities.

constraints from other retailers, and potential new entrants, on their pricing decisions.

4.17. In general the ratio of shelving space for household necessities products to foodstuffs products in a supermarket is around 1 to 10. This means that the floor space provided for one-stop shopping of foodstuffs is much larger than the floor space provided for one-stop shopping of household products and necessities. Therefore, it could be assumed that firms specializing in household products and necessities would only need to operate and compete with a floor space between 2500-4000 square feet (approximate between 240 – 380 square meters). Accordingly, they would have more choices of location than supermarket chains, which need more floor space to provide convenient shopping space for consumers examining and selecting the two categories of foodstuffs and household products and necessities. One can therefore argue that in terms of availability of floor space, the barrier to entry into the market for household products and necessities is lower than the barrier for entry into the market for one-stop shopping (which includes foodstuffs and household products and necessities).

Outlet Coverage and Market Share

4.18. In 2006 it was reported⁷⁵ that in Hong Kong, Singapore and the Pacific Rim the ‘modern grocery trade’ accounts for more than 90% of packaged grocery sales and the markets are dominated by a limited number of retail chains. Supermarkets were reported as the most frequently used channel for the vast majority of shoppers, typically visiting an outlet twice a week or more.

4.19. In July 2013, the Wall Street Journal reported that “*The two largest supermarket chains in Hong Kong— and Wellcome—accounted for a combined 73% market share (of supermarket sector only) last year, according to Euromonitor. ... The Hong Kong-based , established in 1973, has 345 outlets in Hong Kong, Macau and southern China. As of 2012, its 33.1% share of supermarket sales in Hong Kong was second only to Wellcome's 39.8%, CR Vanguard Supermarket was third with 7.8% market share.*”

4.20. Data from the Census and Statistics Department⁷⁶ can help to trace the change over time in the market share based on value of retail sales of foodstuffs⁷⁷ in the supermarket sector⁷⁸ compared to the non-supermarket sector. Figure 4.1 shows that the share of retail sales of food in the supermarket sector (mainly the supermarket chains) gradually increased from 57% in 2003 to 62% in the first half of 2013.

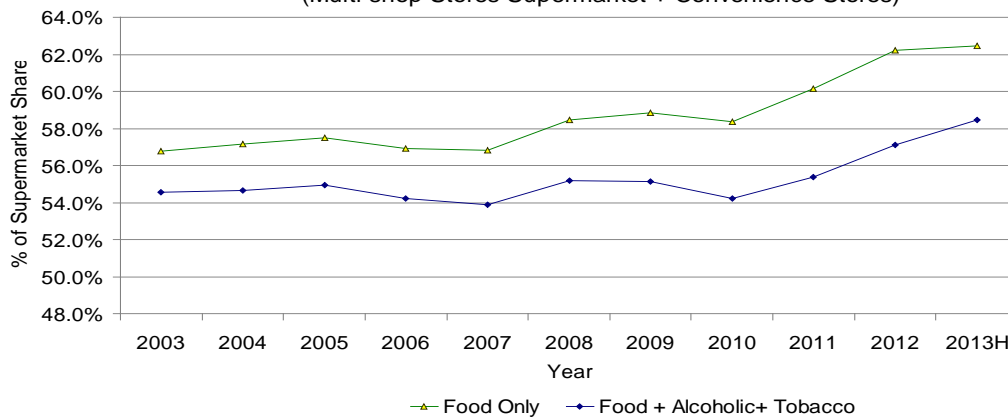
⁷⁵ AC Nielsen *Trends and Insights* AC Nielsen September 2006.

⁷⁶ Census & Statistics Department: Report on Monthly Survey of Retail Sales, Census & Statistics Department various issues.

⁷⁷ Foodstuff includes fish, livestock, poultry (fresh or frozen), fruits, vegetables, bread, pastry, confectionery, biscuits, and other foodstuff.

⁷⁸ The definition of supermarket in Census and Statistics Department includes convenience stores but excludes supermarkets in department stores.

Figure 4.1: Supermarket Share of Retail Sales of Food from 2003 to 2012, (Multi-shop Stores Supermarket + Convenience Stores)



4.21. Another way to assess market shares of the supermarket chains is to examine the number of outlets retailing the products found in their one stop shopping outlets. Table 4.1 shows the number of outlets of large supermarket chains, mid-sized grocery stores, limited assortment discounters and wet markets.

Table 4.1: Number of Retail Chain Outlets⁷⁹
Fresh Produce and Pre-packaged Food

Types of Grocery Outlets	Retail Chain	No. of Outlets in 2013 ⁸⁰
Large Supermarket Chain + Mid-sized Grocery Stores (673 outlets)	Retailer Y	305
	Retailer X	257
	Retailer W	95
	Others	16
Limited Assortment Discounters (212 outlets)	Retailer V	85
	Retailer U	86
	Others	29
	Retailer X Associates	12
Wet Markets (197 outlets)	Link REIT ⁸¹	95
	FEHD ⁸²	102
Total Number of Outlets:		1082

⁷⁹ Source: Grocery Trade Magazine 2011-2012; Websites of Wellcome, Market Place by Jasons, Oliver's The Delicatessen, Three Sixty, PARKnSHOP, CRC Vanguard, city'super, DCH Food Mart, Kai Bo Food Supermarket and PrizeMart.

⁸⁰ The number of grocery outlets to the end of June 2013.

⁸¹ Under the management of The Link Real Estate Investment Trust.

⁸² Wet markets are managed by FEHD, statistics can be found on the web site; <http://www.fehd.gov.hk>.

4.22. It has been observed that outlets under the same large scale operator are broadly distributed throughout Hong Kong and that any operator seldom has more than one outlet within a 500 meter catchment area. The larger the number of outlets per operator, the higher the outlet coverage area of the operator.

4.23. Using the number of outlets as a means of assessing market share can be useful. However, using this alone overlooks the differences that may be found in the amount of sales or turnover of different outlets, and therefore if taken by itself could be misleading. Moreover, treating a wet market (a public market) with many shops operating within it as a single outlet could be equally misleading.

4.24. By using the number of outlets as an indicator of market share, the two supermarket chains, Retailer X and Retailer Y above, would generally not be considered dominant⁸³. However, this observation is at odds in comparison with the observation on “market share” typically reported in the media or in other research studies⁸⁴. This is because the reports usually ignore other types of outlets for food and household necessities and focus on the turnover of the supermarket chains in Hong Kong economy.

Table 4.2: Number of Retail Chain Outlets
Market for Household Necessities

Types of Grocery Outlets	Retail Chain	No. of Outlets in 2013
Large Supermarket Chain + Mid-sized Grocery Stores (673 outlets)	Retailer Y	305
	Retailer X	257
	Retailer W	95
	Others	16
Personal Care Chain Stores (545 outlets)	Retailer T	355
	Retailer S	190
Independent Drug Stores ⁸⁵	No Brands	207
Total Number of Outlets:		1425

4.25. Unfortunately there is no publicly available data on the value of retail

⁸³ Retailer X has 23.8% in food market and 18% in household necessities market whereas Retailer Y has 28.2% in food market and 21.4% in household necessities market in terms of number of outlets.

⁸⁴ A recent report on the supermarket sector of Hong Kong can be found in the following site <http://www.euromonitor.com/grocery-retailers-in-hong-kong-china/report>.

⁸⁵ Only include the members of Hong Kong General Chamber of Pharmacy Limited.

sales for foodstuffs and household necessities to estimate the market share of the major supermarket chains based on turnover. Information on the share of sales or turnover of the two large supermarket chains in comparison with other retailers could provide a better picture on the question of market power.

Estimating Market Power

4.26. The concern with high market concentration rests not only with the potential to exercise unilateral market power, but also with what is termed “coordinated market power” or “collective dominant position”. The Hong Kong Competition Ordinance does not specifically refer to a “collective dominant position” in the Second Conduct Rule but refers to an undertaking that has a “substantial degree of market power”. Whether an ‘undertaking’ can be taken to mean a number of firms acting in a collective dominant position remains to be tested. However, coordinated or collective conduct by a number of powerful competitors acting in concert would be caught by the First Conduct Rule if the conduct prevented, restricted or distorted competition in Hong Kong.

4.27. Concentration ratio tests have been developed over the years through competition law jurisprudence. For example, in *United Brands Co. v Commission (case 27/76) [1978] ECR 207*, the court in the European Union (EU) made it clear that a firm with 40% of the relevant market might well be dominant depending on the structure of the market, and particularly the low market share held by the next largest competitor. In that case, United Brands had a market share between 41-45%, and its closest rival held only 16% of the market. The court considered that United Brands had a position of considerable market power and decided that the existence of ‘fragmented’ competition did not rule out a dominant position. If United Brands had a competitor with 35% market share, it is expected that the findings in that case may have been very different.

4.28. An ‘index’ approach to determining whether there is a competition concern can be found in the Herfindahl-Hirschman Index (HHI) which is a measure of market concentration extensively used by the United States (US) Department of Justice when assessing the impact of merger and acquisition activity on the competitiveness of a market. The index is calculated by adding the sum of the squares of each rival firm in the relevant market⁸⁶ For example, if a defined market had five firms with market shares of 30%, 20%, 20%, 20% and 10%, then the HHI would be: $HHI = (30^2 + 20^2 + 20^2 + 20^2 + 10^2) = 2,200$. The HHI takes into account the relative size and distribution of the firms in a defined market sector. A HHI score closer to 0 implies increasing competition with a large number of firms accounting for relatively small and equal proportions of the market. In contrast, a higher HHI score implies a market with a small number of firms and increasing disparity between the market participants, i.e. one or a limited number of participants dominate the market. The US Department of Justice Antitrust Division defines:

⁸⁶ $HHI = s_1^2 + s_2^2 \dots s_{n-1}^2 + s_n^2$ where s_i , $i=1, 2, \dots, n$ are the market shares recorded by firms active in the defined relevant market.

- (i) Markets in which the HHI is less than 1,500 to be un-concentrated;
- (ii) Markets with a HHI of between 1,500 and 2,500 to be moderately concentrated; and
- (iii) Those in which the HHI is above 2,500 to be concentrated.

4.29. Calculating market power by using the number of outlets may underestimate market power because it does not take into account the size of the customer base for the outlet. The findings of the Council's "Exit Survey" showed that a high proportion of households treat supermarkets as their major choice of outlet for food. Given the proportion of households within the service area of a typical supermarket, it can be assumed that a supermarket outlet serves more households than a wet market or other small retailer.

4.30. By using the average proportion of households choosing different types of outlets for food in the sample of "Exit Survey", a market share concentration ratio (using HHI) can be calculated based on weighted outlet coverage⁸⁷. Having regard to the number of outlets and proportion of households visiting different types of outlets, the HHI of the relevant market of "one-stop shopping of foodstuff is estimated to be 2090 which is moderately concentrated.

4.31. It is also noted that market shares based on the weighted outlet coverage of Retailer X and Retailer Y in the food market are increased to 28.6% and 33.9% respectively, compared to simply using the number of outlets⁸⁸.

4.32. The Government has taken the view, during the legislative consulting process, that an undertaking would be assumed to have a substantial degree of market power if its market share is above 40%. Given that the two supermarket chains have a market share below 40% but above 25%, this neither supports or rejects the notion that any one of the big supermarket chains possesses a substantial degree of market power.

4.33. Market shares based on the weighted outlet coverage of Retailer X and Retailer Y in the household necessities market are calculated at 11.8% and 14.1% respectively⁸⁹. Thus it can be assumed there is no substantial degree of market power as the retailers have less than 25% market shares, which is the 'bright line test' used by the Government during discussions on the proposed Competition Ordinance.

4.34. Using a similar approach, the estimated HHI of "household necessities"

⁸⁷ It is assumed that the amount of spending of each visit to each outlet of each household is the same. There is no detailed information about household preference on brands of retailer, and it is assumed that in choosing a particular category of grocery retailer households are indifferent to brands within the same category of grocery retailer.

⁸⁸ Retailer X has 23.8% in food market whereas Retailer Y has 28.2% in food market in terms of number of outlets.

⁸⁹ Retailer X has 18% in household necessities market whereas Retailer Y has 21.4% in household necessities market in terms of number of outlets.

is therefore calculated to be 979⁹⁰. According to the US Department of Justice concentration test this figure does not represent a concern in terms of concentration ratio. However if two wholly owned business operations of the same corporation, for example a supermarket chain and a related personal care store chain, were treated as one undertaking⁹¹, there would on the face of it, be competition concerns in the market for retailing of household necessities. In these circumstances the company operating both supermarket business Y and the personal care chain store business T cannot be assumed not to have market power⁹².

4.35. It is important to note that neither of the above methods of assessing market share are an unfailingly reliable estimator for market power. Competition authorities with investigative power are able to demand information on sales and other financial data from firms. Access to this type of information would help to more accurately estimate useful market shares as an indicator of market power of any firm of firms under scrutiny. Any future formal investigation of the grocery market by the Hong Kong Competition Commission would no doubt provide a better picture on market shares, and in turn the market power of supermarket chains in Hong Kong.

Geographical Business Environment

4.36. In Hong Kong, retailing activities are accommodated in different types of retail facilities in different districts. These are classified in *Chapter 6, Retail Facilities, The Planning Standards and Guidelines (HKPSG) Report by Planning Department in 2009* and include:

- (i) Shopping malls defined as indoor, air-conditioned and usually centrally-managed shopping centres, which are either free standing or on the lower floors of residential or commercial developments. Shopping malls typically provide the whole range of retailing activities including sales of convenience and comparison goods as well as the provision of retail services and dining services, creating a self-sustaining and one-stop shopping environment. Their size in terms of total gross floor area (GFA) can vary tremendously from large shopping malls with more than 150,000m² to shopping malls of single commercial or residential buildings taking up only a few hundred square metres.
- (ii) Street-front shops defined as ground floor shops within tenement buildings with a street frontage that are commonly found in older parts

⁹⁰ One can interpret that a market with a HHI of 2090 would have the same degree of competition of a market of 5 equal market share firms and a market with a HHI of 979 would have the same degree of competition of a market of 10 equal market share firms.

⁹¹ In Hong Kong, two large corporations operate both supermarket outlets and personal care chain store outlets in the household necessities market.

⁹² The weighted outlet coverage of the two large corporations operating both supermarket outlets and personal care chain store outlets in the household necessities market is 35.9% and 23.6% respectively. The HHI index in this regard is 1872 (i.e., the market would be described as moderately concentrated).

of the urban area. These shops are usually small in size as they are restricted by the size of the building lot. The range of retailing activities accommodated in these shops are similar to those provided in shopping malls. Most of these shops typically extend along the entire street to become shopping streets, with some developing into themed shopping streets selling particular types of goods e.g. dried seafood or sportswear.

- (iii) Hawker permitted places and open air bazaars are designated areas where hawkers with licenses are permitted to sell their products on the street during a specific time period each day. The retailing activities of these hawkers are mainly convenience goods. Examples of these places include the "Ladies' Market" in Mongkok, the Temple Street Night Bazaar in Yau Ma Tei and Jardine's Crescent in Causeway Bay.
- (iv) Wet markets stalls are mostly in purpose-built facilities developed by the Government where a wide range of commodities ranging from fresh produce to household items are offered. Since the use of fresh produce is common in Chinese cooking, wet markets play an important role as an outlet for fresh provisions as some people often visit markets once or twice a day to purchase fresh food items.

4.37. A "Review on Shopping Habits" completed in 2005 by Planning Department (conducted through a household survey, a retailers' survey and structured interviews with major stakeholders) identified the shopping habits of Hong Kong people and a perceived 'retail hierarchy'. The Review revealed that most consumers in Hong Kong shop at outlets close to their place of residence for food and general household goods. However, when they shop for personal and household durable goods, and leisure and entertainment services, the majority would go shopping outside their district of residence.

4.38. Causeway Bay, Mongkok, Tsim Sha Tsui and Wanchai are the most popular shopping districts for these types of goods and service, consistently attracting a much higher percentage of consumers from other shopping areas. Compared with retailers at other locations, a larger proportion of retailers in Wanchai, Causeway Bay, Tsim Sha Tsui and Mongkok claimed that their customers were living in places farther away than the local area.

4.39. Therefore, according to the findings from the retailers' survey, the existence of popular shopping districts in a few limited areas of Hong Kong play a rather insignificant role in the overall shopping pattern for food and general household goods.

4.40. Among all types of retail outlets in Hong Kong, a substantially larger proportion (61.9%) of persons preferred going shopping inside shopping malls than other types of retail outlets. As regards the type of stores preferred by local residents and visitors, a comparatively larger proportion of retailers perceived that "stores in shopping malls" were the preferred type for shopping activities. The possession of substantial financial resources and extensive outlet networks would therefore place supermarket chains and other large

grocery chains in a better bargaining position than individual retailers to negotiate with vendors to operate in shopping malls.

4.41. However, it is noted that 42.3% of respondents stated that "heavy pedestrian flow", rather than the financial resources or extensive outlet network was the most common reason cited by small and independent retailers, including small grocery retailers, for choosing to operate their business along streets, and not in shopping malls. The survey also revealed that 34.0% of respondents stated that "pedestrian flow not heavy enough" was the second most common reason for retailers to close down their business.

4.42. It is understood that the location decision of multi-outlet stores affects the state of market competition between stores and that pedestrian planning also has an important impact on pedestrian flow. This in turn can serve a function of assisting individual grocery retailers to compete with grocery chains, including supermarket chains. The policy of land use for shopping malls and related pedestrian flow planning might therefore determine the availability of space for small and independent retailers on the street front level to introduce a level of competition for other larger competitors.

4.43. Local features such as street planning, pedestrian planning, shopping mall developments and transportation therefore affect the availability of different types of retail facilities; thus affecting competition at the local level. Inevitably the degree of market concentration for the relevant market may differ among districts in Hong Kong. The degree of market concentration at the local level is therefore also important, and should not be ignored even if the degree of concentration in the economy-wide market does not prompt a prima facie concern of market concentration.

Geographical Competition

4.44. It is an established economic principle that a firm has geographic market power over its consumers when the extra costs to those consumers that are incurred to reach the firm's competitors, i.e., offering the same product or the same service but at a lower price, are higher than the price benefit they would get from travelling to and buying the product or service from the firm's competitors.

4.45. The Hong Kong Planning Standards and Guidelines in 2011 issued by Planning Department state that "*Most consumers patronize shops with 10 minutes' walking distance from their place of residence ("shops near home") for food items and general household goods.*"⁹³ Geographical distribution of grocery shops is therefore decisive for wider choices by consumers.

4.46. The location strategy of multi-outlet grocery chains are therefore an important business decision, subject to the constraints of the land planning policy of the government. A market characterized by the presence of multi-outlet grocery chains, of similar sales turnover, would have different

⁹³ Planning Department *Hong Kong Planning Standard Guidelines* Chapter 6 Para 3.5.

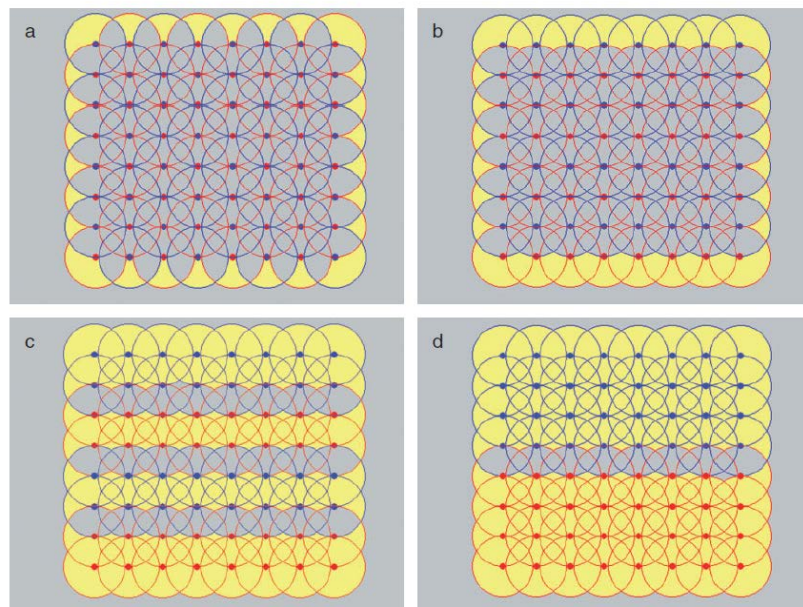
competitive outcomes and choices available to consumers with respect to the location distribution of the outlets of those chains.

4.47. The following diagrams illustrate the geographical location of multi-outlet chains and how their geographic location affects the state of competition. In the diagram, two chains are assumed to operate in the economy (a square city) and each has multi-outlets. Each of the chains is represented by a different color (red and blue), and the circles indicate that each outlet of each chain is located within a 10 minute walking reach by consumers or 500 meters. Different location patterns are demonstrated in Figure 4.2a-d.

4.48. Figure 4.2a and Figure 4.2b show that two chains are located closely to each other, and that many consumers can access both chains (those residing within the grey area) and very few consumers (those residing within the yellow area) are limited to only being able to shop from one single chain (A or B) unless they are willing to incur the travel costs of buying from the other chain.

4.49. If the two chains choose not to engage in “head to head” competition they will have outlets as shown in Figure 4.2c and Figure 4.2d. In these circumstances, many consumers will have limited choices in shopping for groceries. It can be noted that market shares (50%), with respect to number of outlets, remain the same but the state of competition at the local level is quite different. Accordingly, the chains would have different degrees of market power under different location distribution patterns.

Figure 4.2 Geographical Location of Two Multi-outlet Chains⁹⁴



⁹⁴ The figure is extracted from Dirk Stelder: “*Spatial Monopoly of Multi-establishment firms: An Empirical Study for Supermarkets in the Netherlands*” *Regional Science*, Volume 91 Number 1 March 2012, p.182.

4.50. Many factors including the strategic motivation, travel cost and availability of retail places may determine the pattern of the locations of stores, and in turn the state of competition. From Figure 4.2a-d, two observations are noted:

- (i) There may be a lack of head-to-head competition between chains within the boundary of the hypothetical city.
- (ii) The actual state of competition in the various markets within the hypothetical city depends on the location distribution of the geographic pattern of the outlet of the chains.

Lack of Competition on the City Boundary

4.51. In the previous section, it is noted that in theory it is possible that there may be a lack of head-to-head competition between chains in the boundary of the hypothetical city. Over the years, complaints have been made to the Council concerning the lack of choice between grocery outlets and therefore the state of competition. Two particular complaint cases that could be viewed as falling within the problems indicated above in terms of the hypothetical city boundary arose in Tin Shui Wai (TSW) and Yat Tung Estate (YTE). These complaints provide some valid observations as to why it is important to take note of competition at the local level.

Choices of Grocery Retail Outlets in Tin Shu Wai

4.52. The development of TSW began in 1987 with the southern part first developed to house about 200,000 people. It was built complete with all infrastructure transport and service works and a full range of community facilities. According to the 2006 Population Census, the population of TSW at the time was 269,000. The total planned population of TSW in 2009 was estimated to be about 306,000 (an increase of 14%). New housing developments were built and were concentrated in the northern part of TSW.

4.53. Government figures showed that altogether, at the end of 2008, there were 11 public rental housing estates in TSW and 61% of the population was living in public rental flats. When public housing developments were completed in 2009, the number of public rental flats amounted to 56,700.

4.54. There was a major shopping mall (Chung Fu Shopping Centre) in the northern part of TSW, which housed a wet market and two supermarket chains. Walking distance was estimated to be over 15 minutes from Tin Ching Estate and other parts of northern TSW. Other than the shopping mall, there was only one small shopping cluster and two small wet markets offering limited choices of goods for residents in the area.

4.55. According to Government figures, the median monthly domestic household income in northern TSW in 2009 was \$13,750. With about 27,000 households living in the area, the potential annual turnover of groceries sales

in northern TSW was only \$800 million⁹⁵. There were comments at the time as to whether the turnover could support two competing shopping malls in the region.

4.56. The complainants claimed that the price of groceries in northern TSW was higher than in other parts of the Northern New Territories. In weekly price surveys conducted by the Council at the time, it was observed that prices in Tuen Mun and Sheung Shui, for example, for quite a number of items, were not higher than prices in northern TSW. Based on the products surveyed in the first quarter of 2009 and the Council's Wet Market Food Price Index⁹⁶ (WMFPI) it was found that Yuen Long District (which included northern TSW) had the second highest price increase over the sampled period of the third quarter of 2009. However, it should be noted that the higher price observed in Yuen Long district as a whole does not necessarily imply the same higher price level in TSW, given that the socio economic characteristics of TSW area, and therefore price sensitivity, may be quite different to those of Yuen Long district.

Choices of Grocery Retail Outlets in Yat Tung Estate

4.57. YTE is an integrated development consisting of twenty 40 story tower blocks towards the southern part of the town centre of Tung Chung (東涌) situated on the north-western coast of Lantau Island. The town centre has kindergartens, primary and secondary schools, a shopping mall, car park and transport interchange. However, YTE is separated from other public housing developments in Tung Chung and is at least 20 minutes walking distance from the town-centre of Tung Chung where the Tung Chung MTR station is located.

4.58. According to the Government, the estimated population of YTE in 2009 was 39,300. As noted above, YTE is remotely located and has no convenient transport links. The Government proceeded in phases with developing the western part of Tung Chung, having regard to the construction of the Hong Kong - Zhuhai - Macao Bridge. This was done by considering the development and westward expansion of the new town and of eventually building a new MTR station near YTE in the future.

4.59. In order to provide residents of YTE with access MTR services, the MTRCL provides an interchange concession, jointly with New Lantau Bus, for 3 franchised bus routes to ply the route between YTE and Tung Chung MTR Station, and 2 bus routes to ply the route between YTE and Tung Chung North. In total there are currently 14 bus routes serving the estate, with two routes running to Kowloon and four routes to different new towns in the New Territories. The remaining eight routes ply the route between Tung Chung areas and the airport or the Tung Chung Town Centre. Two public light bus services run between the town centre of Tung Chung and the estate.

⁹⁵ Based on Census and Statistic Department estimates, share of household income spend on food excluding meals from home and the miscellaneous items accounts for 18.15%.

⁹⁶ The Index was compiled, on a monthly basis, based on price data gathered in the Council's price survey on a total of 28 food items, including fish, meat, fresh vegetables and fruits, sold in 45 major wet markets in 18 districts throughout Hong Kong.

4.60. According to the district planning policy, there is only one major shopping mall for YTE, with one wet market and one supermarket chain offering choices of goods to consumers in the area.

4.61. Concerned about insufficient choices, complaints were made that the price of groceries is higher in YTE than in Tsuen Wan. However, from weekly price surveys conducted by the Council, it was observed that prices in Tsuen Wan were not lower than prices in Tung Chung for the samples surveyed. The same situation was observed when comparing prices in Tung Chung against those in other districts surveyed for the weekly price surveys.

4.62. There was also conflicting observations from the Council's Wet Market Food Price Index⁹⁷ which measured changes in the price level of food items sold at major wet markets in Hong Kong. The Index indicated that YTE was one of the districts with the smallest price increase in the third quarter of 2010.

4.63. Although the investigations did not find prices to be higher in YTE in comparison with its neighbouring areas (and that no evidence was therefore found to support an allegation of a supermarket exercising market power in geographic areas of demand) the factors that affect local competition remain crucial and should not be overlooked in the future.

4.64. Since 2005, the HA has been providing a range of commercial facilities to provide choices for public housing residents. For the two areas of Tin Shu Wai and Tung Chun, HA manages the Tin Yau Shopping Centre in Tin Shu Wai with a size of about 3,000 square meters, including a wet market, and plans to build a commercial facility in its public housing project in Tung Chung Area 56. This is scheduled for completion in 2016.

Facilitating Local Competition

4.65. Overall, the strategic location decision of a supermarket chain is a contributing factor to the state of competition, and Government land use policy plays a role in determining the number of shopping malls in the area, thus directly determining the possible number, location and distribution of outlets in the area. While land use policy of the Government would to a certain extent influence the entry conditions of the local market, retail market developments are mainly market-driven. Where shopping malls and outlets are eventually located also is ultimately affected by other economic factors.

4.66. Government's land use planning is done at a broad-brush level, i.e. it only provides broad parameters (such as zoning and development intensity) for commercial uses, and does not normally prescribe in detail the various types of commercial use (including retail) on a site or within a development. Nevertheless, the Government closely monitors the land demand-supply and utilization situation and the actual implementation of development on land

⁹⁷ The Index was compiled, on a monthly basis, based on price data gathered in the Council's wet market price survey on a total of 28 food items, including fish, meat, fresh vegetables and fruits, sold in 45 major wet markets in 18 districts throughout Hong Kong.

earmarked for the various land uses is affected by both market-driven decisions of developers and specific policies made by the responsible policy bureaux.

4.67. The market-driven approach of land use policy, such as in responding to the changing demand for land and facilities for various commercial purposes by the market, including where and how retail spaces are to be provided; which types of retail activities are to be provided in such spaces or how they relate to other developments, is affecting the long term development of market competition environment in many sectors. The Council believes that a competition neutral-approach with respect to land use policy would be more beneficial to consumers in Hong Kong.

4.68. It is understood that HA has no plans to further divest its shopping centres and retail facilities, including markets provided for the new public housing estates, in accordance with HA's prevailing policy. The HA will also provide additional retail premises at suitable spots in its existing shopping centres so as to offer more choices to consumers.

4.69. Future investigation could be undertaken to ascertain whether the rental policy of shopping mall owners could play a role in determining the pattern of competition between supermarket chains and other types of retail outlets, such as local drug stores, personal care chain stores and mid-sized grocery stores, in addition to land use policy and strategic decision of chain stores in the local market.

Chapter 5 Competition at the Local Level

5.1. The state of competition at the geographic level is an important initial input to any assessment of competition. Issues such as pricing, service quality and scope of product supplied, associated with respective factors such as customer profiles and demographic factors should also not be overlooked in competition analysis.

5.2. Although retail grocery chain outlets are geographically dispersed, prices are apparently set centrally by the retail chains for all their outlets. It follows therefore, that supermarket chains should be considered to be economy-wide in their form of pricing. Some chains do not have a complete coverage of all areas in Hong Kong. In these circumstances, individual customers across the territories could be faced with geographical variations in price setting, as different areas in Hong Kong are home to different collections of retail outlets.

5.3. Variation in prices can also be compounded and potentially exaggerated by consumers in two ways. Firstly, the distance which an individual would be prepared to travel for a retail grocery service generally extends over only a portion of the economy-wide market. Due to this limited propensity to travel for shopping, many customers will only have access to a limited array of 'economy-wide distributed' grocery products available locally. Secondly, this position of limited outlet coverage is exaggerated if consumers play an important part in determining the level of competition through actively searching for the best prices for their grocery shopping.

5.4. Under such influences the variation of prices, services and product varieties of grocery retailers offered across Hong Kong, whether these are set economy-wide or not, becomes an issue of bias when defining the geographical scope of markets. If the price range of grocery products offered in different districts in Hong Kong is systematically different, location will be seen to have an influence on the realized price set by firms.

Local Market Competition Study

5.5. Typically, as a preliminary first step in a local competition analysis, a local market definition is undertaken, in terms of identifying both a *geographic* and *product* dimension. The market boundary for both these dimensions needs to be defined for the extent of any competition problem to be identified.

5.6. As discussed in Chapter 3, with regard to the *product market* dimension, the conventional approach is to adopt one of two different shopping experiences. First, is the so-called one-stop shopping service. In other words, a typical once a week shopping trip comprising the purchase of all groceries or particular kinds of household items required for a period of about one week. Alternatively there is the secondary shopping experience, which is commonly defined as an occasional small shopping trip to meet spontaneous needs.

5.7. For the purpose of analysing competition between grocery retailers at a local district level, it appears that the *geographic market* could be defined, on a prima facie basis, within a pre-selected catchment area where the supermarket and other grocery shops are situated. A more formal analysis might proceed by using the same methodology that is typically used for the purpose of competitive assessment, i.e., by establishing potential effects on competition within the market arising from market behavior such as price wars and new entry or exit. For the purpose of geographic market definition, this type of analysis attempts to empirically answer the question whether a significant adverse price increase or service deterioration arises across different local areas.

5.8. In the context of shopping at supermarkets, vigorous competition (if present) is usually reflected along the four dimensions of price, quality, range of product and service quality (so-called PQRS measures). The empirical question in the context of geographic market definition, as proposed by Frontier Economics to the UK Competition Commission, is to what extent competition between firms in putative non-competitive markets of various sizes exhibits positive effects on PQRS. Intensity of competition in the putative market can thereby be captured in terms of some measure of market concentration, e.g. number of firms or market shares⁹⁸.

Competitive Assessment: Competition within the market

5.9. Another objective of a typical competition analysis may be an empirical assessment of the intensity of PQRS competition within the market as previously existing before the conduct in question arose. This type of analysis aims at empirically answering the question of whether a reduction in competition within the previously defined market (e.g. as a consequence of a merger or rental practices of the shopping mall operator) entails an adverse downstream effect that is large enough to warrant competition concerns. Once a price-concentration analysis, for example, has been carried out, the answer to this kind of question, for the purpose of competitive assessment, is then a by-product that extends into the analysis of the established geographic market size.

Competitive Assessment: Competition for the market

5.10. Another objective in a competition analysis that, for example, focuses on residential estate supermarkets, might be an empirical analysis of the intensity of competition for entry into local markets. This would amount to an analysis of the bidding among supermarket chains for the right to set up a store in a particular residential housing estate.

5.11. This is particularly important in cases where the final local market structure is likely a local monopoly; because it can be assumed that some residential housing estates in Hong Kong exhibit this feature. Monopoly retailers might argue, for instance, that the high prices they charge locally are justified by the relatively high costs of entering the local market in question (i.e.

⁹⁸ This type of analysis was presented by Frontier Economics to the UK Competition Commission in the Commission's grocery inquiry (2008).

by having had to outbid their rivals who themselves submitted aggressive bids). If supermarkets had to bid for the right to operate a store in a given locality and bidding was aggressively competitive, then this might be a valid defense of the winner's business conduct. However, if bidding was less than competitive, e.g. due to some form of tacit collusive bidding (market sharing etc.) or leveraging of market power⁹⁹, then this conduct would in the first scenario be "serious anti-competitive conduct" and in the second scenario most likely viewed as an abuse of substantial market power.

5.12. Similarly, competition analysis also focuses on bargaining power. In other words, the terms and conditions for products that are supplied to supermarkets. These can serve as an indication of the bargaining power of any of the supermarket chains in Hong Kong. This could be achieved through, for example, an analysis of competition among supermarket chains for the control or the exclusive right over branded products or new products in the marketplace that are expected to be highly in demand.

5.13. If supermarkets absorb all the cost of distributing a product in Hong Kong and the degree of competition for the product is high, then a valid assumption can be made that the terms and conditions adopted by the supermarket operators is a function of the healthy state of retail competition that exists. But if bidding is less than competitive, for example that risks or all or some of the costs are borne by the supplier, then retail competition could be seen as low. How this arises could be due, similar to the previous discussion, to some form of tacit collusive bidding (market sharing etc.) or leveraging of market power.

Methodology of Analysis

5.14. It needs to be emphasized that the data gathering effort for this kind of study is critical for its success, and it is considerable. A market research firm was commissioned by the Council to carry out this work – as opposed to requesting data directly from firms. The advantage is that such firms have experience in collecting data that is representative for the population segment of interest¹⁰⁰. Furthermore, the Council could obtain a single, well-organized dataset and would not have to merge data from different sources, possibly compiled according to different definitions of variables¹⁰¹.

5.15. The relevant data that was collected by the market research firm commissioned by the Council was based on the following two objectives. First, defining a representative sample of estate-based supermarkets in Hong Kong - the representativeness of the sample being critical to eventually being able to generalize any conclusions obtained from an econometric data analysis.

⁹⁹ As mentioned in Chapter 4, there could be a substantial price advantage in bundling rental arrangements between the largest supermarket chain operators and the Link REIT.

¹⁰⁰ Hong Kong based market research firm may actually have a lot of the relevant data at their disposal already, to the extent that they already carry out market research for Hong Kong supermarket chains.

¹⁰¹ For reference, it took the UK Competition Commission about 1 year to reconcile PQRS and margin data from the different supermarket chains operating in the UK.

Second, assessing the PQRS parameters of the goods in question, which entailed

- (i) defining a representative shopping basket, the (generic) items of which can be bought at a typical supermarket that the study should focus on (the composition of the basket thereby had to accord with the product market definition agreed upon);
- (ii) collecting prices on the basket items at each supermarket in the sample, and subsequently pricing the basket, to obtain a price measure (P) for all stores in the sample where prevalence and size of local discounts or other temporary price initiatives (e.g. buy one – get one free, etc.) are taken into consideration;
- (iii) defining and collecting data for each supermarket in the sample on quality measures (Q) related to supermarket shopping in Hong Kong such as restocking frequency for produce and other fresh foods, total floor space, floor space devoted to specific product categories etc.;
- (iv) defining and collecting data for each supermarket in the sample on, product range (R) but not necessary to comprise the entire store range, but could be restricted to certain product categories (e.g. non-alcoholic beverages, dairy products, etc.);
- (v) defining and collecting data for each supermarket in the sample on, dimensions of service (S) that typically refer to opening hours, staff per unit of floor space and hour, number of cashiers, presence of ancillary facilities (such as car park, toilets, café) etc.

5.16. With regard to the geographic dimension, it was necessary to define an expanding sequence of putative geographic markets around each supermarket in the sample. These are typically referred to as *isochrones* and often represent areas of equal maximum drive/travel time (10 minutes, 15 minutes, 20 minutes etc.), starting from the centre (i.e. the supermarket). In the case of Hong Kong, these isochrones are constructed using a walking distance or better travel distance using public transport within a 500-meter boundary.

5.17. For the sequence of isochrones around each supermarket in the sample, the number of competitor stores in the respective isochrones and their market shares had to be determined for assessment of the intensity of competition in the geographical market¹⁰². Data on population and other socio-demographic information of the tertiary planning units¹⁰³ which the supermarket located (statistics on income, family size, age, car ownerships, etc.) were collected to determine the demand feature of the local market.

¹⁰² Competitor stores in a given isochrone are not only the stores in the sample that are located within the isochrone, but any store that is located within the isochrone and sells the basket of items defined.

¹⁰³ For town planning purpose, the whole territory of Hong Kong is divided into 289 Tertiary Planning Units (TPUs) by the Government. These TPUs are aggregated under 52 Secondary Planning Units (SPUs) then further grouped under 9 Primary Planning Units (PPUs) at the highest level.

Findings in the Local Market Competition Study

5.18. A total of 120 supermarket stores of three chains, i.e., those under the Watson Group (ASW), Dairy Farm Group (DFG) and other comparable chain supermarkets (OTH) and 8 limited assortment discounters/small stores (LAD) were sampled. The sample size was around 18% of the population size of the supermarket chains and only 4% of the outlets of LAD in the economy-wide market. They were classified with respect to the local competition environment¹⁰⁴ and district areas, with the breakdown shown in the table below:

Table 5.3: Sampled Retail Chains¹⁰⁵

	ASW	DFG	OTH	Total	LAD
<i>By type</i>					
Type I	7	13	2	22	
Type II	12	9	3	24	3
Type III	27	31	16	74	5
<i>By region</i>					
HK Island East	6	6	3	15	2
HK Island West	8	7	1	16	2
Kowloon East	8	8	6	22	
Kowloon West	5	8	3	16	
Kwai Tsing & Tsuen Wan	5	6	3	14	2
Northern & Tai Po	4	3	2	9	
Shatin & Sai Kung	6	6	2	14	
Tuen Mum & Yuen Long	4	9	1	14	2
Total	46	53	21	120	8

5.19. In theory, if any of the supermarket chains had geographical market power, they could exercise their market power in pricing, quality delivery, product range provided and services level provided. Local markets were classified into three types:

- (i) Type I local market has no competition;
- (ii) Type II local market has some competition; and
- (iii) Type III local market has rival competition.

¹⁰⁴ Type I market represents isolated local market of 500-meter catchment area of supermarket chains without comparable or non-comparable competitors; Type II market represents market having only non-comparable competitors but no comparable competitors within a 500-meter catchment area; and Type III market represents at least one comparable competitor within a 500-meter catchment area.

¹⁰⁵ Details about the data collection are described in Annex 5.1.

5.20. One would expect a difference in price measures, quality measures, product range measures or service level measures amongst different types of competition environments where the supermarket is located. Pricing, quality delivery, product range provided and service levels provided by supermarket chains may also respond to demand characteristics of households. Statistical records of Census 2011 provide some information on the households in local markets such as

- (i) demographic characteristics (ethnicity; age group; gender; usual language; and marital status);
- (ii) education level;
- (iii) economic activities (employment level; monthly income; occupation; and industry);
- (iv) household characteristics (household size; and monthly household income); and
- (v) housing characteristics (type of housing; mortgage payment; and rental payment)

All these could be used as demand factors to isolate the demand effect in the analysis.

5.21. It is noted that amongst all the demographic characteristics, economic characteristics and other characteristics, only the median monthly mortgage payment to medial income ratio is related to the pricing measures of the supermarkets sampled. High monthly mortgage payment households are usually households with working couples facing time constraints who could be assumed to prefer to shop in supermarkets with less frequent visits to alternative grocery outlets such as stalls in wet markets or independent drug stores. It is assumed they would be more subject to accepting price premiums charged by supermarkets, if those premiums did exist.

5.22. After taking into account the demand factors, it was observed that there were only some adverse effects on price, quality, product and service levels with respect to the type of competitive environment consumers faced. While a high price premium was observed in the less competitive environments, the difference was not seen as robust enough to pass the scrutiny of any statistical tests that would factor in a degree of statistical significance.

5.23. Overall, no conclusive evidence could be found that supermarket chains have exercised any perceived market power to detrimentally effect prices and services in localized geographical markets.

Annex 5.1 Data Collection

- a. The objective of the data collection project was to obtain sample data representing the overall market status for the study of competition in the economy wide grocery market. The Council commissioned a market research company to carry out a data collection service on supermarkets chains across different areas of Hong Kong (“the Study”) based on two measures of the degree of competition, viz., PQRS measures and supply and demand side information within Isochrones.
- b. For each sampled grocery store, stock status, prices and availability of promotion for a total of 100 pre-listed items¹⁰⁶ were checked. Those selected items were the highest turnover SKU (stock keeping units) of the fast moving consumer goods of supermarket chains in 2011. In addition, store characteristics, including approximate store size, number of cashiers, accessibility facilities, etc., were obtained.
- c. An operational definition of supermarkets was used in this study in order to define the sampling frame -- supermarkets were defined as grocery stores that included sales of food (other than that sold for consumption in the store), pet food, drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods.
- d. A full list of sizable supermarket chains, based on the criteria below, was developed encompassing a total of 657 stores, including 244 stores under the Watson Group (ASW), 288 stores under the Dairy Farm Group (DFG) and 125 stores under other comparable chain supermarkets (OTH).
- e. Trading brands of ASW stores that were included in the Study were PARKnSHOP, PARKnSHOP Superstore, Gourmet, Taste, International by PARKnSHOP, Great and Fusion. Among these stores, PARKnSHOP and PARKnSHOP Superstore were considered mass-market stores while Gourmet, Taste, International by PARKnSHOP, Great and Fusion were categorized as niche-market stores. Since PARKnSHOP Frozen Food and PARKnSHOP Express were of smaller scale and offered only selected or specialized ranges of products, they did not become part of the master sampling frame. The list of stores was comprised with reference to the stores listed in the website of PARKnSHOP (www.parknshop.com) as at 28 April 2012.
- f. Trading brands of DFG stores that were included in the Study were Wellcome, Wellcome Superstore, ThreeSixty, Market Place by Jason, and Oliver’s. Among these trading brands, Wellcome and Wellcome Superstore were considered mass-market stores while ThreeSixty,

¹⁰⁶ Categories of the sampled basket includes: (1) Fresh fruits / vegetables; (2) Bread, cakes and cereals; (3) Dairy products, soy products and eggs; (4) Oil, condiments and seasonings; (5) Rice and noodles; (6) Canned (or bottled) food; (7) Chilled / Frozen food; (8) Biscuits, candies and snacks; (9) Alcoholic beverages; (10) Non-alcoholic beverages; (11) Pet food; and (12) Toiletries, cleaning products and household goods.

Market Place by Jason, and Oliver's were categorized as niche-market stores. Two Wellcome stores (Lok Ma Chau and Sha Tau Kok) were excluded as they were not accessible to the general public without a valid Closed Area Permit. The list of stores was comprised with reference to the stores listed in the website of Wellcome (www.wellcome.com.hk) as at 28 April 2012.

Trading brands of OTH stores included supermarkets operated by the following groups: CR Vanguard, UNY (HK) Co. (such as APITA), JUSCO (such as JUSCO Supermarket), SOGO Supermarket, City'super and YATA. Lifestyle stores without a food department (e.g. LOG-ON under City'super; JUSCO Living Plaza under JUSCO) were excluded from the Study. The list of stores was referred to the stores listed in the Environmental Protection Department registered retail outlets (<http://www.epd.gov.hk/epd/psb/en/register01.html>) as at 26 April 2012.

- (i) In order to further examine the effect of competition on prices faced by individual supermarkets, supermarkets were further classified into two main types based on the range of products they offered: Comparable Competitors were supermarkets under the three major supermarket chains (ASW, DFG or CR Vanguard); or other independent supermarkets not mentioned in (a) but able to supply at least 90% of basket items and 10 out of 12 divisions of the basket items.
 - (ii) Non-comparable Competitors were chain stores; either the well-established grocery chains (e.g. Kai Bo (佳寶) or Dah Chong (大昌)); or other small-scale retail stores (e.g. grocery stores or convenience stores) that included at least 6 of 12 divisions mentioned.
- g. Sampled supermarkets were further divided into three types depending on the availability of competitors within a 500-meter catchment area:
- (i) Type I: Isolated Local Market – Having no competitors, whether comparable nor non-comparable, within a 500-meter catchment area;
 - (ii) Type II: Non-comparable Competition Local Market – having only non-comparable competitors but no comparable competitors within a 500-meter catchment area;
 - (iii) Type III: With Comparable Competition Local Market – having at least one comparable competitor within a 500-meter catchment area.
- h. The location of the 500-meter catchment area and availability of comparable competitors were determined upon information of supermarkets provided in the GeoInfo Map of the HKSAR Government

(www.map.gov.hk). Grocery stores under the same parent groups were not considered competitive; for instance, a shopping area with two Wellcome Supermarkets or one Wellcome Supermarket and one Market Place by Jason Supermarket and no other competitor store would be defined as Type I (isolated).

- i. Stores were further divided into eight broad regions based on District Council Districts¹⁰⁷ to provide a good representation of different geographical areas.
- j. The sampling procedures involved the following steps:
 - (i) Grouping stores into strata and sorting stores within strata;
 - (ii) Determining sampling ratio for each stratum;
 - (iii) Allocating stores by types of competition within a region; and
 - (iv) Sampling stores using systematic sampling approach.
- k. Stores covered in the master sampling frame were further classified into different strata based on stratifying variables as follows:
 - (i) Supermarket groups (ASW / DFG / OTH);
 - (ii) Broad regions;
 - (iii) Nature of competition (Type I, Type II, Type I/II (to be determined during fieldwork¹⁰⁸) and Type III);
- l. The market research company commissioned by the Council carried out data collection service on supermarket chains across different areas of Hong Kong from 8th June to 1st July 2012. A total of 120 supermarket branches from major supermarket chains (AS Watsons, Dairy Farm Group and other major groups such as CR Vanguard, UNY(HK), JUSCO, SOGO and YATA) were sampled. For each sampled store, stock status, prices and availability of promotional discounts for multiple purchases for a total of 100 pre-listed items were checked. In addition, store characteristics, including approximate store size, number of cashiers, accessibility facilities, etc., were also obtained.

¹⁰⁷ The eight broad regions are Hong Kong Island Western Region covering (i) Central and Western; (ii) Southern; and (iii) the Islands; Hong Kong Island Eastern Region, covering (i) Wanchai; and (ii) Eastern; Kowloon Western Region covering (i) Yau Tsim Mong; and (ii) Sham Shui Po; Kowloon Eastern Region covering (i) Kowloon City; (ii) Wong Tai Sin; and (iii) Kwun Tong; Kwai Tsing and Tsuen Wan ; Northern and Tai Po ; Shatin and Sai Kung ; and Tuen Mun and Yuen Long.

¹⁰⁸ There was a small number of stores that were unable to be classified between Type I and Type II due to insufficient information (hereafter refer to as "Type I/II" stores) before the start of fieldwork. Their final classification was determined during actual fieldwork.

- m. In addition, the stock status, prices and availability of promotional discounts for multiple purchases for a total of 100 pre-listed items, store characteristics, including approximate store size, number of cashiers, accessibility facilities of the following independent / small-scale supermarkets brands, were also obtained in the study for comparison:
- (i) Kai Bo Food Supermarket (「佳寶超級市場」);
 - (ii) DCH Food Mart / DCH Food Mart Deluxe (「大昌食品市場」/ 「大昌食品專門店」);
 - (iii) Ka Hing Supermarket (「家興超級市場」);
 - (iv) Ka Lung Quality Food (「家農優質食品」)
- n. Branches of the independent / small-scale supermarkets brands (Limited Assortment Discounters) located within 500 meters of the sampled chained supermarkets in the PQRS Study of Supermarket Brands were identified. A total of 45 stores in four board regions¹⁰⁹ were located with the following breakdown, depending on whether the reference chained supermarket (i.e. the sampled chained-supermarket with independent / small-scale supermarket located within the 500-meter catchment area) had other competitors within its 500-meter catchment area. The reference supermarket chain could be further classified into Type II or Type III store as follows:
- (i) Type II: With Non-comparable Competition – having only non-comparable competitors and no comparable competitors within a 500-meter catchment area;
 - (ii) Type III: With Comparable Competition – having comparable competitors within a 500-meter catchment area.
- o. The following information was collected:
- (i) For each of the items, the stocking status was noted based on the following classification criteria:
 - (a) In-stock – the item was readily available for sale at the time of fieldwork;
 - (b) Temporary out-of-stock – the item was usually sold in the store (i.e. the price tag of the product was available at the rack) but was out-of-stock at the time of fieldwork, as reflected by an empty rack or a “temporary out-of-stock” label placed next to

¹⁰⁹ The four broad regions are Kowloon Western Region covering (i) Yau Tsim Mong; and (ii) Sham Shui Po; Kowloon Eastern Region covering (i) Kowloon City; (ii) Wong Tai Sin; and (iii) Kwun Tong; and Tuen Mun and Yuen Long.

the price tag of the item; and

- (c) Non-stock – the item was usually not sold in the store, as reflected by having neither the price-tag nor the physical product in the store at the time of fieldwork.
- (ii) For each of the items that were either “in-stock” or “temporary out-of-stock”¹¹⁰, the following price information was collected:
 - (a) purchase price listed for one unit of the item; and
 - (b) if any, the pick-up price for multiple purchases (such as “Buy 2 get 1 free”, “3 for \$10”) by sampled SKUs.
 - (c) for product that was temporary out-of-stock but the price tag was still available at the rack, the price information was collected accordingly. If the price tag was also not available, the price information would be unavailable.
 - (iii) Regarding the quality of services provided by sampled supermarkets, the following observations were recorded:
 - (a) Opening hours (verified against the information available in the companies’ websites);
 - (b) Number of active and inactive cashier counters;
 - (c) Number of self-check-out desks (if any);
 - (d) Number of other staff (e.g. customer services, shopkeepers, etc); and
 - (e) Presence of facilities, including car park, lift, toilet and café.
 - (iv) Regarding the range of products offered by the sampled supermarkets, the following information was collected:
 - (a) Rough estimation of the floor space of each supermarket, using number of footsteps as proxy; and
 - (b) Total number of cashier counters, with breakdown by active vs. inactive counters.

¹¹⁰ Cross-SKU promotions, i.e. promotions involving different products, were excluded.

Chapter 6 Trade Practices of Grocery Market Retailers

6.1. Since the Council published its Report in 2003, there have been allegations, reported in the press and examined by the Government, in regard to anti-competitive practices by chain stores¹¹¹ in the grocery sector. The allegations concerned practices such as predatory behaviour, raising rival's costs, refusals to supply and inducement of resale price maintenance.

Previous Academic Study

6.2. In 2007, a Retailing Survey, conducted by two academics of a local university looked into restrictive trade practices in what was termed the market for fast moving consumer goods¹¹². They noted that

"...results reveal that some possible unfair practices and behavior including stipulating prices charged by suppliers/retailers, restricting suppliers to supply goods/sales services to other retailers, requiring exclusivity from suppliers and restricting retailers to sell other suppliers' goods, etc. did exist in the retailing industry in varying degrees."

6.3. Their findings were based on a survey conducted in December 2006 of a sample of 121 local suppliers to retailers. The study focused on the interplay between suppliers and retailers. Products of the responding suppliers included food/beverages, cosmetics/personal care, pharmaceutical/health, food, household products, rice/oils, dried sea foods. Retailers involved were supermarkets, drug stores/personal care chains, beauty/cosmetics shops.

6.4. A significant proportion (35.1% - 54.2%) of the sample was composed of large suppliers¹¹³ who were found to have been subjected to more restrictions and demands in comparison with small suppliers¹¹⁴. In other words, the presumably greater bargaining power of the larger suppliers did not provide them with an upper hand in the power and conflict balance with the retailers.

6.5. The 2007 Retailing Survey also noted that a high proportion of suppliers were requested by retailers to

- (i) bear the responsibility of damaged goods (63.6%);
- (ii) share promotion fee (62.0%);
- (iii) accept the absolute authority of the retailers to remove the goods from shelf (61.2%);

¹¹¹ Two cases were reported in Competition Policy Advisory Group Report 2006-2007.

¹¹² The study was conducted by Prof. Ho Suk-ching and Prof. Sin Yat-ming on Hong Kong's Retailing Industry in 2007. <http://www.cuhk.edu.hk/cpr/pressrelease/070314e.htm>.

¹¹³ Large suppliers mean those with annual sales value of more than HK\$50,000,000 and medium supplier annual sales value between HK\$5,000,001 and HK\$50,000,000.

¹¹⁴ Small suppliers mean those annual sales value is less than HK\$5,000,000.

- (iv) lower the prices (55.4%);*
- (v) offer incentive rebate unreasonably (46.3%);*
- (vi) accept certain services provided by the retailers (44.6%); and*
- (vii) only few (31.4%) suppliers managed to be able to stipulate the resale prices of the goods on the retailers.*

Council Study Undertaken in 2012

6.6. Accordingly, the Council followed up on the findings of the 2007 Retailing Survey, mentioned above, by conducting a series of interviews with suppliers to establish whether the suppliers still felt constrained by the alleged restrictive practices. Persistent allegations of restrictive practices in the market place can be a strong indication of the presence of market power, and raises potential competition concerns which need closer scrutiny.

6.7. As noted earlier, the Council has no intention and no authority to conduct a formal investigation into allegations of prohibited conduct. Its intention, through interviewing a wide range of suppliers has been to reveal whether some information exists that could facilitate a formal investigation by the Competition Commission in the future.

6.8. While the Council does not have an enforcement role, its approach nevertheless was to gather any prima facie evidence of alleged anticompetitive conduct through anonymous interviews with concerned parties in the trade in a manner similar to that which would be carried out by a competition authority administering competition law. With that in mind, the Council engaged a local competition law academic to help conduct interviews on behalf of the Council by using law students with legal knowledge to conduct the interviews with suppliers. It was expected that the interviewers could pose the right questions designed by the legal expert as the team leader, so that useful information could be collected. A consent form was prepared and signed by all interviewees acknowledging the manner in which the interviews were being carried out, and the purposes of the exercise.

6.9. The sample of interviewees was drawn from all grocery suppliers listed in a grocery trade association magazine. Nineteen out of ninety grocery suppliers responded positively to the invitation. Interviews were conducted between June and August 2012 based on a first version of the questionnaire (Annex 4.1) designed by the local expert.

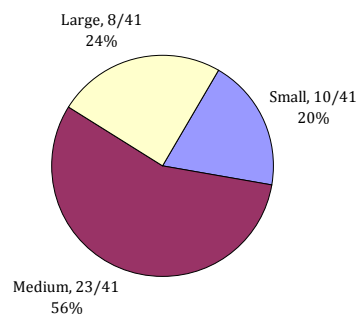
6.10. In addition, the Council also invited participants of a public seminar held on the Competition Ordinance, and organized by a trade association of grocery suppliers, to seek responses from those who did not respond to the Council's previous invitation to complete a similar questionnaire (Annex 4.2). Twenty three suppliers filled in the questionnaires out of 100 conference participants.

6.11. The suppliers in question provide 'groceries' defined in a broad sense to catch all foodstuffs and household supplies, some of which would be perishable. They include food (other than that sold for consumption in the store), drinks (alcoholic and non-alcoholic), cleaning products, toiletries and household goods.

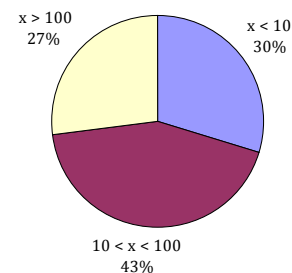
Characteristics of Interviewed Suppliers

6.12. In order to understand the balance of power in the supplier/buyer relationship in Hong Kong, the questionnaire included questions relating to the size of the interviewees. First, suppliers were asked whether they considered themselves to be a small, medium or large company. Second, questions were included relating to the suppliers' turnover and number of brand products (the former was unfortunately removed from the questionnaire when it was modified, and therefore we do not have significant results in this regard). Third, the interviewees were asked to provide an estimate of the percentage of their worldwide sales that took place in Hong Kong.

Percentage of Different Size (In Term of Volume) of Suppliers in the Sample



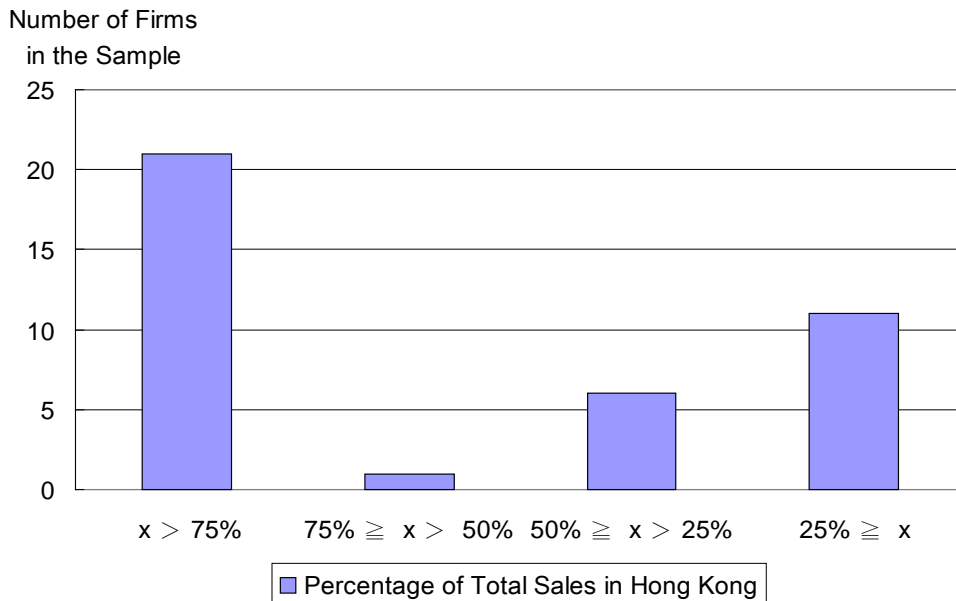
Percentage of Different Size (In Terms of Number of Brands) of Suppliers in the Sample



6.13. The suppliers varied in size. 19.5% (8/41) considered themselves small, 56.1% (23/41) said they were medium, while 24.4% (10/41) saw themselves as large firms¹¹⁵. Most of them were mainly active in Hong Kong, while others operated in many markets around the world. The number of brand products produced by each firm also varied, with 29.8% (11/37) having less than 10 products, 43.2% (16/37) less than 100, and 27% (10/37) 100 or more products. There was no clear relation between their estimated size and the number of brand products produced.

6.14. 53.8% (21/39) of suppliers had over 75% of their operations in Hong Kong, 2.6% (1/39) had between 50 and 75%, 15.4% (6/39) had between 25 and 50%, and 28.2% (11/39) had up to 25%. Therefore, the business of the majority of suppliers interviewed largely relied on their sales performance in Hong Kong.

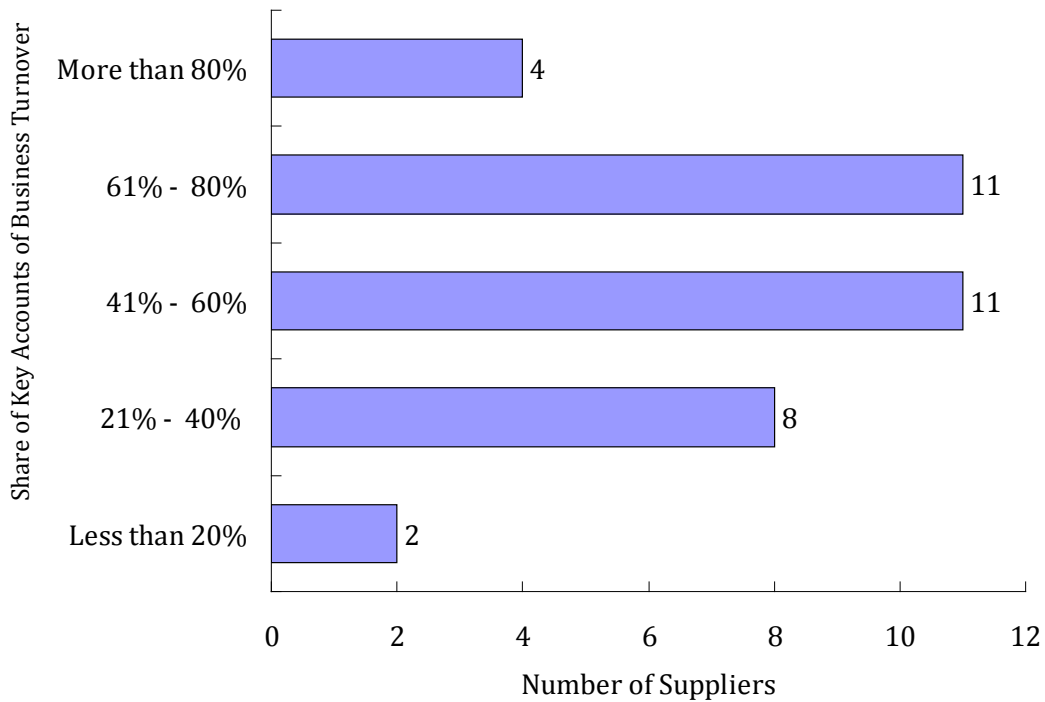
¹¹⁵ One firm did not state its size.



Principal Clients

6.15. All suppliers sold their goods to supermarkets. Some also dealt with convenience stores, personal care chain stores, independent drug stores and category chain stores, as well as other clients (including wholesalers). The number of suppliers mainly trading with key accounts and the number of suppliers mainly trading with open trade was relatively even, but key accounts, which are mainly the supermarket chains, convenience stores chains and personal care store chains, oftentimes accounted for a larger percentage of the sales in the grocery market.

6.16. Only 5.6% (2/36) had up to 20% of their business with key accounts. 22.3% (8/36) had between 20 and 40% of their sales with key accounts. 30.5% (11/36) of interviewees had between 40 and 60% of their sales with key accounts, and another 30.5% (11/36) had between 60 and 80% of sales with key accounts. Up to 11.1% (4/36) had more than 80% of their business with key accounts. As a consequence, a large volume of the suppliers' trade is with key accounts, making this trade essential to their operations.



Supply Contracts

6.17. Virtually all supply contracts have a duration of one year (only 2 suppliers said their contracts were for more than 3 years). This seems to be the standard practice in the industry. Renewal is not automatic in the overwhelming majority of cases. Only 24.4% (10/41) said their contracts were automatically renewed, all others (75.6%, or 31/41) said renewal was subject to certain conditions. When asked whether they thought that the terms that applied to them applied to other suppliers¹¹⁶, opinions were split but 70% thought this was not the case (16/23). No specific conditions for renewal were highlighted.

6.18. 22 interviewees were asked whether, during negotiation of the contracts, they would be in a position to:

- (i) negotiate a figure value¹¹⁷;
- (ii) cross out clauses; or
- (iii) add clauses protecting their company.

6.19. Rather surprisingly, answers greatly differed from supplier to supplier. 72.8% (16/22) said they could indeed negotiate a figure value; 63.6% (14/22) said they could also cross out clauses; only 27.3% said they could add clauses. This divergence could indicate that there are indeed different conditions applied to the various suppliers. The reason behind this differentiated treatment is not apparent from the results of the survey, as there is no clear link

¹¹⁶ The question introduced in the filled questionnaires but was not raised during the interview.

¹¹⁷ The figure value refers to the volume of the sales, the cost of the goods and the promotion expenditure etc. The clause refers special trading terms imposed by the chain store to the suppliers, for example: payment terms.

between the size of the supplier and its bargaining power (as reflected by the answer to the above question).

6.20. Sixty percent (24/40) of suppliers did not have exclusive trade agreements in place. However, one did mention that although this exclusivity is not referred to in the contracts, in practice exclusivity is required. This potential problem is reinforced by the fact that 7 suppliers said that some of their clients had raised problems or objections to them dealing with other clients (complaints mainly relating to prices and discounts). It is relatively common to include terms in the contracts which restrict suppliers' ability to sell to other customers, by requiring prior approval (10 suppliers) or consent (11 suppliers) of the chain stores. Only three suppliers said that this was done via unfavorable terms.

Advertising and Slotting Fees

6.21. Interviewees were asked who covered the cost of advertising the contract goods. In 29.3% (12/41) of cases, the costs were shared to some degree. However, up to 46.3% (19/41) of suppliers said they bore the cost of advertising their products. Only in 24.4 percent (10/41) of cases was advertising covered by the retailer.

6.22. Importantly, in addition to advertising costs, the majority of suppliers (90.2% or 37/41) was required to pay slotting fees for the placing/shelving of their products within the retailer's premises (one supplier specified that it paid for the display of new products, not their shelving). Of these suppliers, 38.9% (14/36) expressed the view that the slotting fees charged were excessive. Moreover, in the original questionnaire interviewees were asked whether they were satisfied with the way their product was promoted and displayed. Nine of 19 suppliers interviewed said they were not.

Resale Price Maintenance

6.23. Up to 94.7% (36/38) of suppliers said they made price recommendations to their buyers, sometimes by suggesting a minimum price, other times a maximum price, and other times a price range. However, some suppliers, 26.8% (11/41) said they did not allow discounts on their products. Only one supplier said it applied a compulsory minimum price, while another specified it required its buyers to stick to a compulsory maximum price.

6.24. The two alleged cases of resale price maintenance examined by the Council (discussed in Chapter 7) did not seem to bear any link to the size of the supplier, and the limited number of cases in which such compulsory resale prices can be observed is therefore not sufficient to determine with certainty whether resale price maintenance is a problem in the sector.

6.25. It is worth noting that during the interview suppliers were asked whether any customers had complained about discounts offered on the contract goods by other competing customers. Virtually all those asked said that this was the case, and the complaints came principally from supermarkets. Given the sensitivity of this question, the question was removed from the questionnaire that was distributed at the abovementioned trade association seminar.

Supply and Production of Competing Goods

6.26. In 90% (36/40) of cases, suppliers said that their buyers engaged in the production of goods that might be in competition with the contract goods they provided. This was particularly so when it came to customers such as chain stores and supermarkets.

6.27. A significant number, 86.0% of overall responses, indicated that retailers engaged in house brands that directly competed with their own products (17 out of 19 interviews or 89.5%, and 20 out of 24 questionnaires or 83.3%). Out of the 17 interviewees who supplied retailers that were also engaged in the supply of competing goods, two of them said that the retailers would provide house brand products matching their top sales products. Another interviewee mentioned that the sales of one of its leading brand product dropped 20% when the competing house brand product was first introduced.

Damaged and Unsold Goods

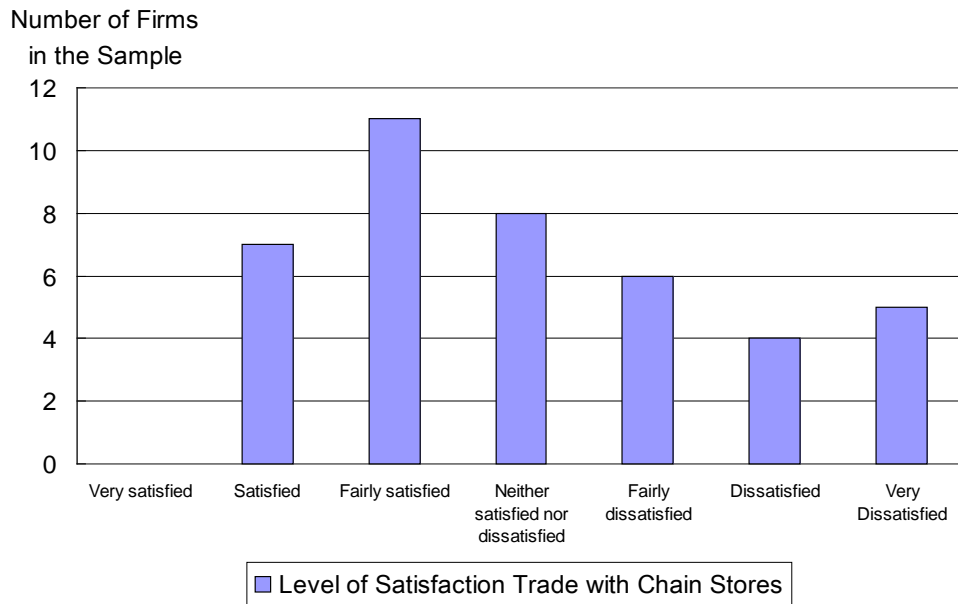
6.28. All companies asked said they had to pay a damaged goods allowance, which effectively meant they were liable for goods that were damaged and oftentimes simply unsold. It should be noted that this question was introduced only in the last 23 questionnaires, but even those interviewed earlier mentioned and referred to the practices of a damaged goods allowance by chain stores.

6.29. The policy regarding unsold goods seemed to vary depending on the supplier. Nonetheless, 65.9% of suppliers had to take those unsold goods back with a returned goods policy. Moreover, in 64.7 percent of cases (22/34) unsold goods had an impact on the supply price. That impact was mainly either an obligation on the supplier to reduce the supply price for unsold goods during the contract period, or an obligation to compensate the buyer for those unsold or returned goods. This could naturally bear an important impact on the supplier, particularly given that in many cases the most important retailers are engaged in the production of competing goods.

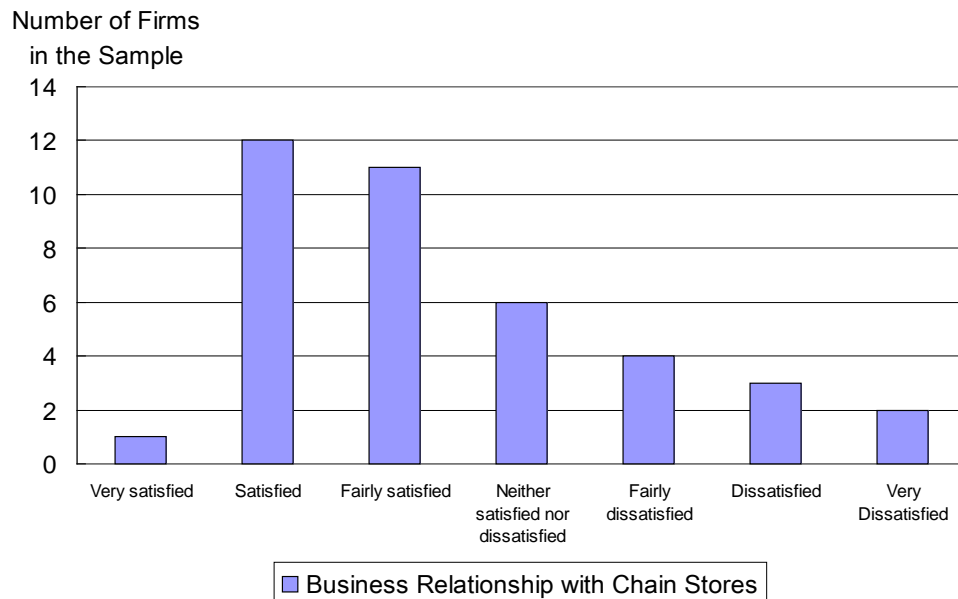
6.30. Some of the interviewees (4 of the 19 about 21.1%) indicated that the policy on unsold goods implied by the retailers had an impact on the supply price of the goods, and the policy on unsold goods imposed additional costs on suppliers. However, there was not enough evidence to determine whether the additional costs were absorbed by the suppliers, retailers or consumers. The questionnaire did not specifically ask about the impact of unsold goods policy on the supply price of the goods.

6.31. The level of satisfaction varied greatly from supplier to supplier, so it was difficult to draw general conclusions. Firstly, suppliers were asked whether they were satisfied with their clients' compliance of their contractual obligations. While none of them said they were very satisfied, 17.1% (7/41) were satisfied, and 26.8% (11/41) fairly satisfied. A total of 19.5% (8/41) were neither satisfied nor dissatisfied. A small number, 14.6% (6/41) were fairly dissatisfied, 9.8% (4/41) were dissatisfied and a further 12.2% (5/41) were very dissatisfied. This

meant that a total of 36.6% of suppliers expressed different levels of dissatisfaction.



6.32. Secondly, interviewees were asked whether they were satisfied with the relationship with their clients. A small number, 2.6% (1/39) said they were very satisfied; 30.8% (12/39) were satisfied; 28.2% (11/39) were fairly satisfied; 15.4% (6/39) were neither satisfied nor dissatisfied; 10.3% (4/39) were fairly dissatisfied; 7.7% (3/39) were dissatisfied; and finally, 5% (2/39) were very dissatisfied. As a consequence, satisfaction levels are higher when it comes to the overall relationship with clients, with only 23% of interviewees expressing dissatisfaction.



Conclusion: Potential Issues to Consider

6.33. The above study into the grocery market in Hong Kong revealed certain trade practices issues that could require further examination: First of all, it would appear that when it comes to the negotiation of supply contracts, suppliers may be at a disadvantaged position vis-à-vis retailers. The former oftentimes have bargaining power to include clauses to protect their interests, and the latter seem to impose uneven, opaque conditions for the renewal of the contracts.

6.34. Exclusivity is sometimes required by big retailers either in the supply contract or subsequently via pressure through emails or other means of communication. Whether the exclusivity arrangement might limit consumer choices in the market depends on the duration of the exclusivity. In addition, any burdensome arrangements placed on suppliers could also be an indicator of market power.

6.35. Although there are no specific indications of resale price maintenance being enforced in the industry, as suppliers tend to merely recommend prices and allow discounts, it appears that some retailers have tried to prevent others from offering discounts, by complaining to suppliers and threatening to stop dealing with them if the suppliers do not prevent those competitors from offering the goods at a lower price. It is possible that some retailers might try to use the supplier to coordinate prices with other retailers.

6.36. Big retailers, in particular supermarkets, frequently engage in the production of competing goods to those provided by suppliers. The conduct of those retailers in charging those suppliers (who are also competitors) slotting fees, a contribution to the retailers' advertising expenditure, a damaged goods allowance, and forcing them to take back/bear the cost of unsold goods, means that they are placing the suppliers' products at a disadvantage in relation to those produced by the big retailers. If those retailers were found to possess a substantial degree of market power, further investigation could be required to see whether prohibitions against abuse of market power could be applicable to these practices.

Annex 6.1

Grocery Market Study 2012 by the HK Consumer Council Questionnaire for the Interview with Suppliers Prepared by Prof. Sandra MARCO COLINO Faculty of Law, The Chinese University of Hong Kong

I. GENERAL

1. Would you consider yourself a small, medium or large supplier?
2. On a rough estimate, what is your company's annual worldwide turnover?

Below HKD 10 million	
HKD 10-25 million	
HKD 25-50 million	
HKD 50-75 million	
HKD 75-100 million	
Over HKD 100 million (please specify)	

3. Since when have you been selling your product/s in Hong Kong?

4. Are you active in any other geographic areas? If yes, please provide details

China	
South East Asia	
Europe	
US and Canada	
Central and/or South America	
Australia and New Zealand	
Others (please specify)	

5. How many brand products currently in your category offered in supply

Less than 10	
10-25	
25-75	
100-200	
More than 200	

6. What percentage of your worldwide sales would you roughly estimate take place in Hong Kong?

Less than 10 per cent	
10-25 per cent	
25-50 per cent	
50-75 per cent	
75-100 per cent	

7. Who are your principal clients in Hong Kong? Please answer in terms of percentage of sales in Hong Kong (e.g. over 30%, over 50%, etc). Note: if you do not wish to provide specific names, please just specify the *kind* of clientele you mainly work with (e.g. supermarkets, wet markets, small shops...)

Names	Kind of Clientele				Percentage of HK Sales			
	Super-market	Convenience Stores	Category Chain Stores	Others	Below 10%	10% to 20%	25% to 50%	Above 50%

8. What is the estimated percentage of sales split between key accounts (principal chains) and open trade (independent shops)? For instance: 30% key accounts:70% open trade

II. SUPPLY CONTRACTS - REQUIREMENTS

(Following questions are only referred to principal/key clients in Hong Kong)

Duration

9. What is the usual duration of these contracts? If they vary according to customers, please provide details

Less than 6 months	
6 months-1 year	
1-3 years	
Over 3 years (please specify)	

10. Can the contracts be renewed?

Yes	
No	

If yes, please provide details of the conditions for renewal:

11. Are there any specific conditions imposed on either of the parties for the renewal?

Yes	
No	

12. Do you think the conditions imposed are standard for every supplier for the renewal?

Yes	
No	

13. Do you think the agreement between you and the key clients are negotiable?

Negotiation Flexibility	YES	NO
Can negotiate figure value (% or \$ value) in the agreement		
Can cross-out clauses in the agreement		
Can add clauses in the agreement		

Exclusivity Requirements

14. Do you have any exclusive lease agreements in place?

Yes	
No	

If yes, was the exclusivity clause instigated by yourself or your client?

Instigated by yourself	
Instigated by your client	

15. Do any of the terms of your agreement restrict or preclude you from selling to any other group of customers or clientele? If yes, please provide details

Prior approval	
With consent	
Terms unfavourable	

16. Regardless of the contractual terms, have any of your clients ever raised any problems with regard to your dealings with other clients? If yes, please provide details

Yes	
No	

Category Management

17. According to your contract, which party is in charge of the advertising and promotion of the product? Please provide details

Your company	
Your client	

18. Do you pay any (additional) slotting fees for shelving your product in a specific area of the retailer's shop?

Yes	
No	

19. If you pay slotting fees, do you find the retail price determined by the retailer appropriate?

Yes	
No	

20. Are you satisfied with the way your product is promoted and displayed by your customers? If no, please provide details

Yes	
No	

Pricing

21. Do you require your clients to re-sell your products at a specific price, or within a specified price range?

Yes	
No	

If yes, please provide details:

Compulsory minimum price	
Recommended minimum price	
Compulsory maximum price	
Recommended maximum price	

22. Do you allow your customers to offer discounts on the products you supply?

Yes	
No	

If yes, please provide details re. the conditions under which these discounts may be granted.

23. Have there been any instances where any of your customers have raised complaints about other customers' discount schemes on your products?

Yes	
No	

If yes, please provide details

Non-Compete Obligations

24. Do your contracts contain any clauses obliging customers not to engage in the production of goods or services that could be in competition with your products?

Yes	
No	

If yes, please provide details

25. If you answered yes to question 22, what is the usual duration of the non-compete obligation?

Less than 6 months	
6 months-1 year	
1-3 years	
3-5 years	
5-10 years	
More than 10 years	

26. Are any of your customers engaged in the production or supply with its own brand of competing goods or services?

Yes	
No	

If yes, please provide details

Unsold goods

27. What is the policy regarding the contract goods that remain unsold? Please specify which one of the following options applies to big chains, wet markets and independent shops:

The buyer keeps those goods	
The buyer requires our company to take back those goods	

28. Does this policy have an impact on the supply price of the goods?

Yes	
No	

If yes, please provide details (specifying which option applies to big chains, wet markets and independent shops):

Our company is obliged to reduce the supply price for those unsold goods	
Our company is obliged to reduce the supply price of those unsold goods and all other goods purchased together with the unsold goods	
Our company is obliged to return the money paid by the buyer for those goods in full	
There are no changes to the supply price of those unsold goods, but discounts are required for subsequent purchases	
Other (please specify)	

III. SATISFACTION

29. How satisfied are you with your customers' compliance of their contractual obligations?

Very satisfied	
Satisfied	
Fairly satisfied	
Fairly dissatisfied	
Dissatisfied	
Very dissatisfied	

30. How satisfied are you with your overall relationship with your clients?

Very satisfied	
Satisfied	
Fairly satisfied	
Fairly dissatisfied	
Dissatisfied	
Very dissatisfied	

31. Please provide us with any additional comments on any problems that you may have encountered in the sale of your products to the various retailers in Hong Kong

Thank you for your time

Annex 6.2

Grocery Market Study 2012 by the Hong Kong Consumer Council Working with Prof. Sandra MARCO COLINO Faculty of Law, The Chinese University of Hong Kong

Purpose of survey:

- Examine the state of competition of grocery market in Hong Kong with respect to geographic factors, product dimensions and service attributes.
- Examine the market power of relevant players in the grocery market in Hong Kong.

Procedures of data collection including methods used would ensure confidentiality of personal and research data. Neither the name of any participants in the survey nor anything able to identify the company will be mentioned in the finding under any condition. The information collected is solely for the above research purpose in the form of publications and/or reports.

Section A: General

1. Would you consider your company a small, medium or large supplier?

Small supplier Medium supplier Large supplier

2. How many brand products currently in your category are offered in supply?

0-9 10-25 26-75 76-100 101-200 More than 200

3. What percentage of your sales takes place in Hong Kong? (a rough estimate)

Less than 9 % 10%-25% 26%-50%
 51%-75% 76%-100%

4. Who are your principal clients in Hong Kong? (tick more than one if applicable)

Supermarkets Convenience Stores Category Chain Stores
 Others

5. What is the estimated percentage of sales split between key accounts (principal chains or others) and open trade (independent shops)?

0%-20% key accounts 21%-40% key accounts 41-60% key accounts
 61%-80% key accounts 81%-100% key accounts

Section B: Following Questions applied to the Supply Contract of Key Accounts

6. What is the usual duration of the supply contracts with principal/key clients in Hong Kong?

Less than 1 year 1 – 3 years More than 3 years

7. Do the supply contracts automatically be renewed?

Yes No

8. Do you think the contract or trading terms (imposed on you) applying to every supplier?

Yes No

9. Are there any specific conditions imposed on either of the parties for the renewal?

Yes, please specify: _____

No

10. Do you think the terms of the agreement between you and your key client(s) are flexible enough for your company to

Negotiation Flexibility	YES	NO
Negotiate figure value (% or \$ value) in the agreement		
Cross-out clauses unfavourable to your company		
Add clauses protecting your company		

Exclusive Requirements

11. Do you have any exclusive trade agreements in place?

Yes, the exclusive clause was instigated by your company

Yes, the exclusive clause was instigated by your client

No

12. Do any of the terms in your agreement restrict you from supplying to any other group of customers or clientele?

Prior approval With consent Yes, but with unfavourable terms

Category Management:

13. According to your contract with key retailer, which party is usually in charge of the advertising and promotion of the product?

Your company The retailer

14. Do you pay any (additional) slotting fees for shelving your product in a specific area or place in the retailer's shop?

Yes No

15. If you pay slotting fees, do you find the retail price set by the retailer appropriate match with promotion in the retail outlet?

Yes No

Pricing:

16. Do you require your clients to re-sell your products at a specified price, or within a specified price range?

- Yes, at a compulsory minimum price
 Yes, at a recommended minimum price
 Yes, at a compulsory maximum price
 Yes, at a recommended maximum price
 No

17. Do you allow your clients to offer discounts on the products you supply?

Yes, please specify the conditions under which the discounts may be granted

No

Non-compete Obligation

18. Do your contracts contain any clauses prevent customers to engage in the production of goods or services that could be in competition with your products?

- Yes (Proceed to Question 19)
 No (Proceed to Question 20)

19. What is the usual duration of the non-compete obligation?

- Less than 6 months 6 months – 1 year 1-3 years 3-5 years
 5-10 years More than 10 years

20. Are any of your customers engaged in the production or supply with its own brand of competing goods or services?

Yes No

Unsold goods:

21. Does your company pay for damage good allowance?

Yes No

22. What is the policy regarding unsold contracted goods?

- The retailer keeps those goods
- Our company would take back those goods

23. Does this policy have an impact on the supply price of the goods?

- Yes, your company is obliged to reduce the supply price for those unsold goods
- Yes, your company is obliged to reduce the supply price of those unsold goods and all other goods purchased together with the unsold goods
- Yes, your company is obliged to return the money paid by the buyer for those goods in full
- Yes, there are no changes to the supply price of those unsold goods, but discounts are required for subsequent purchases
- No impact

Satisfaction:

24. How satisfied are you with your clients' compliance of their contractual obligations?

- Very satisfied
- Satisfied
- Fairly satisfied
- Neither satisfied nor dissatisfied
- Fairly dissatisfied
- Dissatisfied
- Very dissatisfied

25. How satisfied are you with your overall relationship with your clients?

- Very satisfied
- Satisfied
- Fairly satisfied
- Neither satisfied nor dissatisfied
- Fairly dissatisfied
- Dissatisfied
- Very dissatisfied

Thank you for your time

Chapter 7: Allegations of Anti-Competitive Practices

7.1. Over the years, a number of alleged anti-competitive conduct cases in the Hong Kong grocery sector have been referred to the Council either by the Government or some complainants for detailed study. In undertaking this work, the Council has applied the principles of competition analysis typically used by overseas jurisdictions, in addition to the principles outlined in the Government's competition policy guidelines. Possible effects on market competition and economic efficiency arising from the complaints were explored and reported to the complainant or the Government for further consideration.

Competition Policy in Hong Kong

7.2. Before 2012, Hong Kong did not have a law to prohibit anti-competitive practices. However, there was a "Statement on Competition Policy" which noted that the Government would take administrative or legal steps as appropriate to remove any restrictive practices that impair economic efficiency or free trade.

7.3. The First Conduct Rule of the recently introduced Competition Ordinance under Section 6 seeks to prohibit an undertaking from making or giving effect to an agreement if the object or effect of the practice or agreement is to prevent, restrict or distort competition in Hong Kong; in particular, agreements that directly or indirectly fix selling prices. However, agreements such as resale price maintenance are not specifically identified either as an example of a 'hardcore' anticompetitive agreement, or a per se anticompetitive agreement that automatically violates the law.

7.4. The Second Conduct Rule of the Competition Ordinance under section 21 seeks to prohibit an undertaking with a substantial degree of market power from imposing a practice if the object or effect of the practice is to prevent, restrict or distort competition in Hong Kong. Practices such as exclusive dealing, for example, would need to be considered in the context of the relevant market in which a firm operates to determine whether the practice is to be treated as an abuse of market power in violation of the law.

7.5. Whether a vertical restrictive agreement should be viewed as a legitimate way of influencing how a supplier's product is distributed and marketed has been the subject of much debate in other jurisdictions that have long standing competition laws. Restricting a supplier's vertical supply chain (intra-brand competition) can have positive benefits for competition between different brands by promoting inter-brand competition such as improved quality of service.

7.6. However, there are two situations where vertical arrangements may give rise to some competitive concerns. First, a supplier with a substantial degree of market power could use a vertical agreement to limit market access of competing suppliers. Second, a vertical supply arrangement may, in effect, be the means by which direct competitors agree to limit competition between them.

7.7. In overseas jurisdictions, the prohibited effects of an abuse of substantial market power could include: anticompetitive foreclosure of a competitor, raising barriers to entry, and withdrawal of products or services from the market or a reduction in the quality of the services offered.

7.8. There have been many allegations of conduct raising competition concerns in the grocery sector obtained by the Council from past inquiries in the sector. The Council has consistently taken the view that it should only have a concern with conduct that has an appreciable effect on harming the process of competition, or the welfare of consumers, and not simply constitute harm to an individual competitor. Examples of investigations into allegations of anti-competitive practices in the grocery sector can be found in Annual Reports of the Competition Policy Advisory Group (COMPAG)¹¹⁸.

Competitive Effect of Exclusive Arrangements

7.9. One common allegation has been that supermarkets abused their market power by leveraging their position in the retail market to restrict competition for household products. There have been cases where a supermarket allegedly placed impediments on suppliers, which prevented them from supplying wet tissues and toilet detergents to other competing retail outlets¹¹⁹. In the absence of a competition law (such as the current Competition Ordinance) the competition issue that arose and the test applied was whether the practice was for the purpose of substantially lessening competition and whether it could be concluded that the supermarket's behaviour amounted to anti-competitive conduct that had the effect of limiting market accessibility or contestability and impairing economic efficiency.

7.10. In market economies, markets are defined as areas of rivalry in which buyers and sellers compete for the best possible deal in terms of price, product choice and quality of service. With regard to complaints on exclusivity, overseas competition law authorities start with identifying the rivals in the relevant market (in this case, some household necessities products) from a supply and demand perspective:

- (i) The market for wholesale supply of household necessities to retail outlets in the economy (in this case, the Hong Kong economy); and

¹¹⁸ COMPAG Annual Report 2007-2008 and Annual Report 2011-2012.

¹¹⁹ In August 2006, a supplier (the Supplier) lodged a complaint that a supermarket had engaged in anti-competitive conduct to COMPAG. Specifically, the supplier claimed that

- a. the supermarket had unilaterally raised the retail price of the supplier's products above an agreed level; and
- b. after displaying the supplier's products for only a few months, the supermarket had removed them from its shelves upon the launch of similar products under its own brand name, despite the supermarket's earlier indication that the fee paid by the supplier covered a one-year period. (COMPAG Annual Report 2007-2008 2008 pp.8-9).

- (ii) The market for retail demand of household necessities by consumers through retail outlets in the economy.

7.11. The market for supply of household products to retail outlets would in general encompass a range of stores: supermarkets, personal care chain stores, convenience stores, grocery stores, local drug stores and house-ware stores. Each of these outlets, depending on the range of product offered, would compete with each other to obtain the best deal from suppliers and vice versa.

7.12. It is important to determine what other types of outlets in addition to supermarkets are also the source of supply for the products in question. If one can find evidence that most other outlets do not stock the target products this would assist in determining the relevant market for the product in question.

7.13. It is worth noting that from the 2007 Retailing Survey by Prof. Ho Suk-ching and Prof. Sin Yat-ming (mentioned in Para. 6.2) 71% of 46 respondents (from a total of 121 suppliers surveyed) claimed to have exclusivity restraints placed on them¹²⁰ by retailers. In the Council's interview with suppliers in 2012, noted in Chapter 6, 40% of suppliers had exclusive or restrictive trade agreements in place¹²¹.

7.14. It is understood that exclusivity is sometimes demanded by large retailers either through the terms of the supply contract or subsequently through pressure via emails or other means of communication. While an exclusivity arrangement might limit consumer choices the main competitive harm of exclusive dealing is foreclosure of competitors. The presence of exclusive restraints dampens the opportunity for new entrants to secure market share; and find alternative sources of retail.

7.15. As mentioned in Chapter 3, the 2005 Planning Department survey found that there was a strong consumer preference for *supermarkets (80%) and ordinary drug stores (14.5%)* over other forms of retailing for general household. On the other hand, the finding from the Council's "Exit Survey" in 2012 indicated that many households (*over 50% of households in the sample*) treated personal care chain stores or drug stores as close substitutes of supermarkets for retail services of daily necessities.

7.16. If close-substitutes of the household daily necessities in question could only be found in supermarket chains, house-ware chains, and local/individual drug stores, and not personal care chain stores, the market for supply of those products would be subsequently narrower.

Market Power

7.17. In terms of the market for retail demand of household necessities

¹²⁰ <http://www.cuhk.edu.hk/cpr/pressrelease/070314e.htm> Survey on Hong Kong's Retailing Industry Reveals that Unfair Practices Generally Exist in Supplier / Retailer Relationship.

¹²¹ Exclusivity sometimes is not always referred to in the contracts. Many suppliers mentioned that some of their clients had raised problems or objections to them dealing with other clients (complaints mainly relating to prices and discounts) post contract.

through retail outlets, it was indicated in Chapter 3, that with respect to “one stop shopping” of household necessities, there is increasing competitive pressure from house-ware chains, mid-sized grocery chains, some limited assortment discounters and independent drug stores. Moreover, indications of market power by large supermarket chains were not shown in price margins over others at the retail level in a composite basket of household necessities.

7.18. Therefore, in terms of the market for wholesale supply of household necessities to retail outlets in Hong Kong, it is necessary to demonstrate (if it is to be suggested there is a concern) that the market power of the supermarket was reflected in its buying power rather than on its price over margins at the retail level.

7.19. In theory, supermarkets’ relationships with their suppliers can be characterized as either a “market framework”, where there are numerous suppliers in the market and a single market price is offered by the retailer to all suppliers for the product in question; or a “bargaining framework”, where suppliers are relatively concentrated and prices and terms are negotiated bilaterally. As there were few branded products for the wet tissues and toilet detergents in question, the suppliers for the products in question and the two largest supermarkets would have adopted the bargaining framework.

7.20. The 2007 Retailing Survey conducted by Prof. Ho Suk-ching and Prof. Sin Yat-ming also found that if suppliers were dependent on supermarkets only, an overwhelming majority of them were subjected to more restrictions and demands imposed by supermarkets. The survey also found that large suppliers with annual sales value of more than HK\$50,000,000 did not have an upper hand in bargaining power (or countervailing bargaining power) with the major supermarket chains.

7.21. There are three ways in which substantial buying power might adversely affect competition and in turn harm consumers. Firstly under the market framework, if suppliers display unit production costs that increase with the volume produced, powerful buyers might withhold demand (known as “demand withholding”) so as to reduce their purchase price and generate a better margin on the sale of these goods. If the buyers also have market power (i.e. an ability to set the price they sell at), they can sell the reduced quantity purchased at higher prices to consumers with the result that consumers will pay higher prices and purchase a lesser volume.

7.22. Secondly, buying power might suppress investment by suppliers in process and product innovation as well as in maintenance if it reduces suppliers’ expected returns from such investment. Such effects on investment may arise both within a market framework and within a bargaining framework. Consumers would be harmed by a lower rate of innovation and product quality in future.

7.23. Thirdly, within a bargaining framework, if the terms of trade to small scale retailers with less buying power worsen when larger retailers (i.e. supermarkets) with stronger buying power obtain better terms, then the offer to

final consumers by small scale retailers may also worsen and the price charged by these small scale retailers to consumers may increase.

7.24. The extent of buying power of the major supermarkets in Hong Kong can therefore be considered a concern as the studies carried out have identified supermarkets' abilities to extract high slotting fees and impose unequal restrictions on suppliers.

7.25. A report by the US Department of Agriculture in 2006¹²² noted that all major supermarkets in Hong Kong require expensive listing fees and charged fees to determine how a product is put on their shelves. Moreover, the report revealed that many US exporters encountered numerous burdensome trading terms demanded from supermarkets, such as promotional discounts (fees for number of discount promotions offered during the year), back-end income (flat rebate per year based on the annual turnover), distribution allowance (fee for distributing the products from the supermarkets' warehouse to their branch stores) and incentive rebate (a percentage of turnover rebated to the supermarkets in case sales exceed the agreed amount).

Effect of the Conduct on Competition

7.26. In the absence of power exercised by suppliers, it is reasonable to assume that retailers would be able to exercise discretion as to retail prices, the manner in which products are displayed, and when they should be removed from display. A commercial dispute between supplier and retailer where the end result could be that choices to consumers are limited may raise concerns as to whether the marketplace is working in the interests of consumer welfare.

7.27. There have been complaints examined by the Council concerning the stocking of an own-brand product to the detriment of another competing product, and disagreements on retail prices. In isolation, these disputes between suppliers and powerful buyers could be considered as merely commercial disputes, because any detriment to consumers that arises from a supplier not being able to supply its products to one particular retail chain, or having its price unilaterally raised, is not considered as a major area of concern for competition in the marketplace. However, it is the cumulative effect of similar disputes, across a broad spectrum of products and over a prolonged period, that arouses concern from competition authorities.

7.28. For example, own-label products are becoming increasingly common in Hong Kong and other jurisdictions. They are generally stratified into either first choice, or super-saving with an emphasis on low price. Supermarkets argue that the presence of these products has increased competition across the dimensions of price, choice and quality.

7.29. The presence of own-label products being sold alongside branded products could result in detrimental effects on suppliers of branded products, due to the fact that suppliers or manufacturers of branded goods find

¹²² USDA Foreign Agricultural Services *Hong Kong Market Development Report Export Guide* GAIN Report Number HK6024, 2006.

themselves in the position of effectively having to share their marketing plans, product formulations and launching plans with their competitors (i.e. the supermarkets they are dealing with) several months prior to the actual launch of their branded products. Another issue that has been raised in other jurisdictions is that own-label versions of a branded product are sometimes subjected to “copycat” behaviour, because they imitate the packaging of popular brands with the intention of misinforming consumers as to the nature and reputation of the products. This kind of issue is more appropriately handled within intellectual property rights law. A competition authority would typically be more interested in possible anti-competitive practices where retailers can impose higher business risks to brand suppliers by manipulation of the retail price of the brand products and favouring their own-label products.

Does the Conduct Benefit Consumers?

7.30. One common element of these complaints has been that the suppliers efforts at introducing new products into the marketplace is thwarted by retailer’s actions in altering the supplier’s pricing decisions, and substituting the suppliers products with its own-label products. On the face of the complaint, these actions could be considered as denying consumers optimal product choices and prices, and stifling innovation.

7.31. However, it could also be argued that introduction of own-label products may provide consumers with low-price alternatives which increases consumers’ choices. An AC Nielsen study in 2005¹²³ found that:

- (i) an average of 42% of consumers disagreed that ‘private label’ products had cheap, off-putting packaging;
- (ii) 69% agreed that they were extremely good value for money; and
- (iii) 62% considered their quality to be at least as good as the ‘big brands’.

7.32. The findings suggested therefore that while some consumers hold the view that the quality of own-label products are not as good as that of branded products, a significant number of consumers believe that own-label products are good value for money.

7.33. Whether own-label products in question distort competition can be determined by a retailer’s intention and its ability to foreclose access to their shelves from brands that may effectively compete with their own-label product and, most importantly, threaten their ability to maximize profits. On the other hand, it might be reasonable for supermarkets to exercise their discretion, from time to time, due to limited floor space, and to refine the most profitable product selection presented to consumers. However, if this was claimed to be the case in regard to the supplier’s complaint (in the matters examined by the Council) it raises the question as to why the supermarket entered into negotiations with the supplier in the first place.

¹²³ AC Nielsen “*The Power of Private Label: An Insight into Consumer Attitudes*” AC Nielsen 2005.

7.34. The presence of choices between own-label and branded products allows consumers to at least have a choice based on perceptions of quality. Whatever the motives behind the actions of the supermarket in removing the supplier's products, the conduct limited the number of products available for consumers.

7.35. In this case, a reasonable view could nevertheless be taken that consumers are not harmed by the retailer's conduct. For example, prior to the conduct, there was one brand of the products supplied by the supplier in the market. After the conduct, there was one brand supplied by the supermarket in the market. The only difference is the identity of the brand. The actions of the supermarket in unilaterally increasing the price of the supplier's products, subsequently removing those products, followed by the introduction of its own-label product, could only be reasonably assumed (in the absence of clear evidence otherwise) as an action to foreclose access to a competitor, with detrimental consequences to consumer welfare, only if one could show that the supplier's branded products were superior in quality to the own-brand products. Otherwise it could be argued that consumers seem to have suffered no harm.

7.36. It is important to also note that the supermarket was operating in a market place that had many other large competitors. The response to actions of other retailers in regard to its own-label products such as pricing conduct and shelf space allocation and access, would also need to be taken into account, given the market concentration thresholds that exist in the Hong Kong supermarket sector and the potential response from rivals.

Minimum Resale Price Maintenance

7.37. Another issue related to vertical agreements is that of resale price maintenance between suppliers and retailers, and whether such agreements have any anti-competitive effect in the market¹²⁴. In the past the Council has received many complaints from retailers against suppliers alleging the enforcement of resale price maintenance (RPM) by withholding supplies unless the retailer increases the retail price to that specified by the supplier. The basic competition issue of RPM can be illustrated through a case received by the Council regarding supply of a popular soft-drink product.

¹²⁴ In November 2011, the COMPAG Secretariat received two complaints each from a LegCo Member, alleging the following practices of some supermarket chains and retail chain stores with market power were anti-competitive.

- a. supermarket chains were alleged to have pressured a soft drinks supplier not to supply soft drinks products to a local retailer who had refused to comply with the recommended price for a particular soft drinks product set by the supplier;
- b. a supermarket chain was alleged to have pressured a supplier not to supply instant noodles of a particular brand to a local retailer if the retailer refused to comply with the recommended price for the product set by the supplier (*COMPAG Annual Report 2011-2012* 2012 pp.12-13).

Legal Approaches in Comparable Jurisdictions

7.38. The practice of RPM is examined by competition agencies in other comparable jurisdictions, either as:

- (i) a per se contravention, with specific definitions as to what constitutes the contravention; or
- (ii) a breach of the general horizontal or vertical agreement provisions, which makes the conduct subject to a “competition test”; or
- (iii) exempted outright, as in the Singaporean approach, which grants exemption to all vertical agreements subject to possible future revocation.

RPM as Outright Exemption from Competition Law

7.39. Section 34 of the Singapore (SG) Competition Act prohibits anticompetitive horizontal agreements between competitors, but generally does not apply to vertical conduct such as RPM by virtue of the “Vertical Agreements Exclusion” found in Section 8 of the Third Schedule of the Act. However, where the anticompetitive effect of the RPM is considered to outweigh its pro-competitive effect, the Minister of Trade and Industry may issue an order to remove the “Vertical Agreement Exclusion”, and subject the specific instance RPM in question to the general prohibition in Section 34, thereby placing it under scrutiny to determine whether it is actually anticompetitive.

7.40. The SG Competition Commission had not at the time of preparing this study, taken any action in regard to allegations of RPM in Singapore. This is most likely due to the fact that:

- (i) Vertical agreements in general are automatically exempted from the prohibition on anticompetitive agreements;
- (ii) There is a legislative premise that vertical arrangements are assumed to be efficiency enhancing; and that
- (iii) Exemptions to vertical conduct remain unquestioned unless a reasonable case with great public concern has brought to Government’s attention.

RPM as Hardcore Restriction of Competition

7.41. Australia (AU) has a specific and detailed provision prohibiting RPM per se under Section 48 of the Australian Competition and Consumer Act. The prohibition and evidentiary requirements are spelled out in extensive detail, covering a wide range of possible scenarios, such as the inducement of a supplier to engage in practice and secondary supplier restrictions. However, there has been debate over the years as to whether the per se prohibition of RPM should be removed and the existing provision replaced with a competition test.

7.42. Prohibition of minimum RPM in the US was in place since the 1911 “Dr. Miles Case” where the Supreme Court affirmed that a minimum RPM scheme was unreasonable and thus offended Section 1 of the Sherman Act. That decision identified the economic effect of minimum RPM as indistinguishable from naked horizontal price fixing by a cartel.

7.43. RPM has long been treated as a hardcore restriction of competition law in the EU, according to Article 101(1) of the EU Treaty which prohibits agreements directly or indirectly fixing purchase or selling prices or any other trading conditions which have the object or effect of preventing, restricting or distorting competition. An exemption may apply through Article 101(3) if the conduct contributes to improving the production or distribution of goods or promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit.

7.44. RPM is also considered as a hardcore restriction under UK law. In 2004, the UK OFT which administers the UK Competition Act published “Guidelines on Vertical Agreements”. The guidelines further clarified that “the important issue is generally not the form of the vertical restraint but its effect on competition”.

Rule of Reason – United States Leegin Case

7.45. In 2007, the US Supreme Court overruled the “Dr. Miles Case” by the decision in the “Leegin Creative Leather Products Case” (“Leegin Case”). The Court held that vertical price restraints such as “minimum advertised pricing” are not per se unlawful but must be judged under the “rule of reason”. The Court noted that RPM could, in some situations, stimulate inter-brand competition; encourage resellers to invest in services or promotions which allow consumers to choose between low end and premium brands; or it could eliminate the detrimental practice of free-riding.

7.46. Inspired by the US Leegin Case, the European Commission published its revised Guidelines on Vertical Restraints in 2010. The Commission noted that while RPM would presume to fall within Article 101(1) and be unlikely to fulfil the conditions for exemption under Article 101(3), the Guidelines allow the Commission to have the authority to make the presumption rebuttable. This would leave open the possibility for suppliers to plead an efficiency defence, and the Commission or the Court would need to assess the likely negative effects on competition.

Hong Kong Market Conditions

7.47. A Sample Guideline for the Hong Kong Competition Ordinance tabled in a Bills Committee meeting of the Legislative Council stated that identifying the boundaries of the relevant market is the first step towards understanding the dynamics and degree of competition between undertakings. Market definition provides a framework for competition analysis and is important in the process of determining whether agreements between undertakings have as their effect the prevention, restriction or distortion of competition under the First Conduct Rule. Where an agreement involves undertakings whose combined share of the relevant market is low, the agreement is generally unlikely to raise

competition concerns.

7.48. The European Competition Network (ECN) noted,¹²⁵ in the process of examining competition in the soft drink industry, and the relevant market, that the biggest source of added value in the food industry comes from unique formulas and branding. Brand loyalty, regularly fostered by extensive marketing campaigns, was said to be particularly strong for carbonated soft drinks, and that this industry segment was traditionally the most profitable. The ECN also noted that strong brands, together with well established distribution channels and high capital investment, had long been regarded as major barriers to entry for newcomers.

7.49. Other industry segments, which could be seen as separate markets, included bottled water, fruit and vegetables juices, concentrates, sports and energy drinks, ready-to-drink coffee and tea as well as “Asian specialty drinks”. It is worth noting that there is a recent consumer trend towards healthier drink options other than carbonated soft drinks. Incumbents had reacted to this trend by developing their own new products or by acquiring producers for healthier drink options.

7.50. The product which was the subject of the Council’s inquiry into alleged RPM was a particular carbonated soft-drink for on-the-spot consumption. The main outlets for soft drink are supermarkets, convenience stores, petrol stations, vending machines and fast food chains. It is important to note that a few of the brands had become “must-stock” items and thus their supply could become a very important feature for competition at the retail and distribution level. Coca-Cola and Pepsi are undoubtedly recognized for their brand strength and global image and therefore appear to be the “must stock” items for a retailer in the market for on-the-spot consumption of soft drinks.

7.51. In defining the relevant market, the EU Commission approaches demand-side substitutability by gauging whether customers for the product in question can switch readily to a similar product in response to a small but permanent price increase (between 5% and 10%). In determining supply-side substitutability, the question is whether other suppliers can readily switch production to substitute products and sell them in the relevant market. Competition authorities in the UK, US, SG and AU take a similar approach, where the process is typically described as the application of “a small but significant non-transitory increase price” rule.

7.52. For the purposes of determining the relevant soft drink market in the Hong Kong complaint described above, a consumer survey could have been undertaken posing questions aimed at assessing purchasing decisions of Hong Kong consumers, based on location and occasion, and change in choice in the face of a hypothetical change in price. The results could have been instructive in determining the role that certain products, including certain brands of soft drinks, have on the supply side. The Council did not undertake

¹²⁵ European Competition Network, ECN Subgroup Food, ‘*ECN Activities in the Food Sector – Report on competition law enforcement and market monitoring activities by European competition authorities in the food sector*’ Section 3.2.9, May 2012.

a survey along these lines but assumed that the product in question was in fact a 'must stock' item and refusing to supply the product would have an adverse effect on a retailer in the market for on the spot consumption of soft drink.

7.53. RPM is a vertical restraint imposed on a reseller irrespective of the cost structure of the reseller. Although the definition of RPM differs between competition law jurisdictions, a majority of laws do not apply to the imposition of recommended prices. RPM typically refers only to minimum resale price fixing and does not include maximum retail price fixing.

7.54. EU Regulation states that vertical agreements with minimum and resale prices should not be exempted even if they do not have an appreciable effect on competition, because in effect a contractual arrangement establishing a minimum price would be an example of an arrangement with the object of fixing a price. This would include indirect means of price fixing such as fixing the distribution margin, or fixing the maximum level of discount a retailer can offer off the assigned price level.

Evidence to Prove Resale Price Maintenance

7.55. The evidence offered in the case examined by the Council relied to a large extent on alleged conversations between the sales representative of the soft drink supplier and the complainant retailer where the retailer was promised "business as usual" if discounting of the soft drink stopped. In addition, it was alleged that the sales representative was under pressure from a competing retailer to stop the complainant discounting the soft drink.

7.56. The fact that competitors are inducing a supplier to refuse supply to another competitor who offers lower prices would be considered as restricting competition. Evidence of conversations between the supplier and competing retailers, where pressure was placed by those retailers on the supplier to ensure that no one is selling below the recommended price, would be required to prove that the inducement of RPM had taken place. Unless competing retailers and others were forthcoming in providing more information about their agreements and contact with the parties involved, there is little likelihood of obtaining sufficient evidence to conclude that competitors have engaged in prohibited conduct.

Effect of the Conduct on Competition

7.57. Academic literature on antitrust, studies by competition authorities and court cases in comparable jurisdictions suggest potential anticompetitive detriments of RPM as follows:

- (i) Removing pressure on retailer's margins – RPM may reduce efficiencies by preventing price competition by more efficient retailers. It may also prevent or hinder the entry and the expansion of retail formats based on low prices.
- (ii) Facilitating collusion – Collusion between competitors could be facilitated by enhanced price transparency, which would make it easier to detect whether any competitor has deviated from the agreed price.

- (iii) Restricting output – Sales expansion could be restricted, particularly if the market has oligopolistic tendencies where a significant portion of the market is covered by RPM agreements.
- (iv) De facto price agreement – RPM eliminates intra-brand price competition, thereby having a similar effect as arising from a horizontal agreement.
- (v) Removing pressure on suppliers' margins – Allied suppliers may prefer to agree with RPM, as it serves as a commitment not to lower the price for subsequent resellers and therefore reduce the pressure to compete with price.
- (vi) Foreclosing entry –Where it is implemented by a supplier with market power, it could be used to foreclose smaller rivals. The increased margin that RPM may offer to retailers could entice the retailers to favour the brand with high profit margins over rival brands, and in turn not to stock the rival products.

7.58. The basic test to identify efficiency loss as a result of the conduct is to measure the change in output or sales that have taken place in the relevant market, as if the price being set was simply adjusting to the competitive price level. However, unless there is cooperation by related parties, it is very difficult to collate accurate historical information on price and market shares and other market data from market players to draw any conclusion in this respect.

7.59. Retailers sell bundles of products and stock a range of products. Based on impressions gleaned from consumer research, the Council understands that consumers prefer to go to a single retailer which they know will stock the desired products at reasonable prices, rather than shop around in different stores for individual products. Therefore, consumers tend to choose between retailers on the basis of their reputation for good product range and general low prices.

7.60. Loss leading is an effective method in gaining reputation for general low prices to overcome incumbents' market power in this regard, and establish a market reputation. New entrants at the retail level might therefore wish to reduce prices of leading products and then advertise an image as a low price retailer. If a supplier enforces a fixed sales price policy for popular products this could limit a new entrant's loss leading strategy to compete with other existing large retailers.

Effect of the Conduct on Economic Efficiency

7.61. Schedule 1 of the Competition Ordinance provides that the First Conduct Rule and the Second Conduct Rule will not apply to an agreement that enhances or would likely enhance overall economic efficiency. The underlying principle of the exclusion is that conduct, where it yields efficiency outweighs anti-competitive harm, and may therefore be exempted from the law.

Overseas competition law jurisdictions consider the following as economic efficiencies¹²⁶ that could emanate from RPM:

- (i) Promoting new entry – When a supplier introduces a new product, RPM can be helpful during the introductory period to expand demand by inducing retailers to better account for supplier's interest and promote the new product. A high profit margin secured by RPM may provide retailers with incentive to invest more on sales efforts.
- (ii) Orderly Franchising Operations – Fixed resale prices may be necessary to organise a uniform distribution format in franchise operations.
- (iii) Prevent free-riding – The extra margin set by RPM could serve to assist in products that require presale service or particular display facilities. If a significant number of consumers take advantage of the services provided by the high end retailers to make their choice, but purchase at a different outlet which does not invest in these services, such consumer behaviour may in fact reduce the ability for high end retailers to invest in these add-on services which are considered as demand enhancing.
- (iv) Creating choice between premium and low end product – Suppliers' motives behind imposing RPM on different retailers could be strategically important in differentiating premium and low grade products within the brand.

7.62. Apart from refrigeration, it is obvious that the selling of soft drinks for on-the-spot consumption requires no pre-sale or after-sale service. When a consumer looks for a drink for immediate consumption, it is highly unlikely that one would go from one shop to another to look for discounts. The efficiency arguments mentioned above are therefore unlikely to be applicable in this case.

Limitations

7.63. In the past, when the Council conducted investigations into complaints alleging anti-competitive effect in the grocery market, it interviewed complainants and shops involved and examined the complaints with reference to its previous studies into the supermarket and retail chain sectors, relevant overseas experience and the guidelines set out in the Government's Statement on Competition Policy.

7.64. Although there were prima facie cases based on the information

¹²⁶ Given that the exemption in Schedule 1 of the Competition Ordinance is explicitly modelled after Article 101(3) of the EU Treaty, it would be necessary to refer to whether these efficiency arguments are accepted under EU law http://europa.eu/legislation_summaries/competition/firms/l26114_en.htm.

provided by the complainants, the identifiable facts unearthed by the Council did not satisfy a reasonable level of proof to establish a causal relation between the practice being conducted in the market and the object of restricting competition. The common conclusion of investigations was that in the absence of investigative powers, the Council would not be able to unequivocally verify the facts to ascertain whether there was evidence to substantiate allegations.

7.65. With the enactment of the Competition Ordinance, the Council now assumes the Competition Commission with its investigative powers will be able to go beyond what the Council was able to conclude in these cases.

Chapter 8: Administrative Approach to Resolve Disputes

8.1. This Chapter introduces for discussion and possible implementation in Hong Kong the self-regulatory and mandatory industry code models adopted in Australia and the United Kingdom (U.K.) for the grocery sector. Both jurisdictions have competition laws similar to that in Hong Kong, yet both have also introduced administrative measures to address concerns on unfair trade practices and competition in the grocery sector, and in particular the 'one stop shopping' (supermarket) sector. The measures were introduced following studies in their markets, similar to what has taken place (albeit it on a limited scale) in Hong Kong.

8.2. The Council considers that similar administrative measures should be considered and thought given as to whether they could be incorporated in a model appropriate to Hong Kong as a means of enhancing the fairness and long term development of the sector in Hong Kong.

8.3. A self-regulatory code of conduct that provides some oversight of inter-business relations can be seen as more appropriate where allegations of oppressive conduct by retailers are alleged, even though the conduct is not necessarily in breach of competition law. Much of the conduct typically complained of in this regard relates to private commercial disputes between suppliers and retailers and is best dealt with by a self-regulatory code that utilizes administrative and mutually agreed processes. This is not to say that competition law does not have a role. While some overseas competition authorities have supported self regulation through codes and mediation to play an important role in the industry have also applied their competition laws against unfair trade practices of retailers where they have used market power to squeeze the margins¹²⁷ of competitors or suppliers¹²⁸.

8.4. The Council's 2003 grocery market study, described previously, did not find strong evidence to substantiate any specific allegation of restrictive practices by supermarket chains in the grocery market or that alleged conduct by undertakings with alleged substantial market power restricted or distorted market competition. At the time, the Council looked into the possibility of having a self-regulatory framework with a code of conduct to facilitate better relations between suppliers and retailers in the grocery sector. This was in response to not only indications of serious concerns by some in the sector, but also a reflection of the Government's preference in having self regulatory mechanisms to resolve business disputes with the ultimate benefit of improving the business environment and improving consumer welfare.

8.5. It is noted that the two industry code models adopted in Australia and

¹²⁷ Hailer Alberto: "Is A Margin Squeeze An Antitrust Or A Regulatory Violation?" *Journal of Competition Law & Economics* Vol. 6 (4): 879-890 November 3, 2010.

¹²⁸ Countries deal with unfair trade practices are mentioned in Chapter 2 and the typical reference case is from *Australian Competition & Consumer Commission v Australian Safeway Stores Pty Limited* [2003] FCAFC 149 Federal Court of Australia 2003.

<http://www.austlii.edu.au/au/cases/cth/FCAFC/2003/149.html>

the U.K. were both introduced as government initiatives, and not by the sector itself. In Australia the model adopted by its Government was in response to a report of an inquiry by the Joint Select Committee of the Australian Parliament in 1999 on fairness and market failure in the retailing sector.

8.6. In the UK a mandatory model backed by the Groceries Code Adjudicator Bill is currently being debated in the Second Reading Stage in the UK Parliament. The model was suggested by the U.K. Competition Commission in its second enquiry into the grocery market in 2009. It urged the Government to strengthen the existing Grocery Supply Code of Practices (the Groceries Code) which was adopted after the first enquiry in 2006. Its preferred model is that the Groceries Code should be overseen and enforced by an independent adjudicator.

Australian Self-Regulatory Model

8.7. The grocery sector in Australia is heavily concentrated and oligopolistic in nature with two large retail supermarket chains across Australia and a small number of other localised chains each having significant degrees of economic influence. A report on an inquiry in 1999 found that although consumers appeared to be benefitting from competitive forces in the existing market structure, the major chains placed significant pressures on small and independent retailers. It was considered that a significant problem had to be addressed in relation to the practices of big business at the supply level, and with respect to the larger competitors at the retail level.

8.8. Despite the fact that there were many complaints received during the course of the inquiry which did not raise anti-competitive issues that could be dealt with by the competition authority under competition law, some intervention was nevertheless considered necessary. An industry-funded committee¹²⁹ appointed by the Australian Government was formed to develop a self-regulatory industry code for retail grocery industry.

8.9. The Australian Code¹³⁰ is a voluntary code of conduct for the produce and grocery industry and is intended to cover all industry participants in the Australian produce and grocery industry on a voluntary basis. Participating organisations and businesses commit themselves to promoting the Code and adopting it in their own internal dispute resolution procedures. The Code is independently reviewed every 3 years to evaluate progress in the sector.

8.10. The objects of the Code are to:

- (i) promote fair and equitable trading practices amongst industry participants;
- (ii) encourage fair play and open communication between industry participants as a means of avoiding disputes; and

¹²⁹ Retail Grocery Industry Code of Conduct Committee (RGICCC).

¹³⁰ The Produce and Grocery Industry Code of Conduct.

- (iii) provide a simple, accessible and non-legalistic dispute resolution mechanism for industry participants in the event of a dispute.

8.11. The Code is based on principles of fair trade and fair competition such that all industry participants support an efficient and competitive produce and grocery industry. The principles accord with equal respect to: (a) the right of retailers to buy the best produce at the best price; and (b) the right of suppliers to have their produce fairly evaluated for purchase against clear and objective standards and specifications; and (c) industry participants support the right of suppliers and retailers to freely negotiate the terms and conditions of any supply contracts.

8.12. The Code applies to industry participants in their vertical relationships with one another but is not intended to cover consumers. It is intended to guide the conduct of industry participants but does not constitute a contract between them and is not intended to be any substitute to regulatory guidelines under competition law. The provisions of the Code are subject to all applicable legislation in Australia and all rights and obligations arising under common law.

8.13. The Australian Model promotes a two-stage dispute resolution scheme. Stage 1 encourages industry participants to attempt a resolution of disputes between themselves in the first instance. Stage 2 then allows unresolved disputes to be raised with the Industry Ombudsman.

8.14. The Industry Ombudsman (The Produce and Grocery Industry Ombudsman) was set up by the industry to resolve disputes over supply of produce and grocery to markets and retailers. The Ombudsman is appointed and funded by the Australian Government under contract. In addition to appointing mediators to resolve disputes in accordance with the suggested Dispute Resolution Procedures provided by the Code, the roles of the Industry Ombudsman include:

- (i) producing an annual report on the Office of the Produce and Grocery Industry Ombudsman;
- (ii) reporting and consulting with the industry-funded committee on the operation and effectiveness of the Code annually, or as requested; and
- (iii) reporting to the Australian Federal Government Minister for Agriculture, Fisheries and Forestry on the operation and effectiveness of the Code and the Industry Ombudsman.

8.15. The Australian model emphasizes openness in dispute resolution procedures to address imbalances in bargaining power between large chain stores and small suppliers. However, the Industry Ombudsman and dispute resolution procedures could be seen as not achieving their objectives effectively due to the fact that there are no real forms of protection from commercial retaliation for making allegations and raising concerns with the sector. A major issue appears to be the fact that the Industry Ombudsman does not have sufficient power to enable breaches of the Code to be

investigated and rectified by those at fault.

Proposed Mandatory Model in United Kingdom

8.16. The grocery sector in the U.K. is dominated by four major supermarkets. Although there are around 93,000 grocery stores across the country, large grocery retailers account for about 85% of total grocery sales with the largest four accounting for two-thirds of the total turnover in the sector. In April 2008 the U.K. Competition Commission completed an enquiry into the UK grocery sector, following long-running concerns that the four major chains exploited their market power to put undue pressure on suppliers and to compete unfairly with smaller retailers.

8.17. Notwithstanding the U.K. Competition Commission's view that the country's big four supermarkets were delivering a 'good deal for consumers', it was considered that the big four U.K. supermarkets had substantial power over suppliers operating in the grocery market. The Competition Commission was also of the view that the supermarkets dictated terms and changed agreements to suit their profit margins which resulted in longer hours, lower pay and poor working conditions for workers as suppliers tried to meet these demands. If a supplier wanted to raise a complaint about terms of trade, they risked losing business from the supermarkets and access to lucrative UK markets.

8.18. The conduct of the big four supermarkets was considered to have an "adverse effect on competition" because the transfer of excessive risk and unexpected costs to suppliers through various supply chain practices, if unchecked, would have an adverse effect on investment and innovation in the supply chain, and ultimately on consumers. To counteract the effect, the Commission proposed making changes to the supermarket code of practice governing these relations.

8.19. The supermarket code of practice was originally formed as part of the statutory undertakings given to the U.K. Government under competition law (Fair Trading Act 1973) following the U.K. Competition Commission's report in 2000 on the supply of groceries from multiple stores in U.K. The four big supermarkets had each given statutory undertakings to comply with the code.

8.20. To address the 'adverse effect on competition' of supply chain practices, it was decided to implement remedies by updating the supermarket code of practice to a Grocery Code and by imposing stringent measures such as:

- (i) All grocery retailers with groceries turnover in excess of £1 billion a year are included within its scope.
- (ii) An overarching fair-dealing provision is included.
- (iii) Grocery retailers are prohibited from making retrospective adjustments to terms and conditions of supply.

- (iv) Grocery retailers are prohibited from entering into arrangements with suppliers that result in suppliers being held liable for losses due to shrinkage.
- (v) Grocery retailers are required to enter into binding arbitration to resolve any dispute with a supplier arising under the Groceries Code.
- (vi) Grocery retailers are required to keep written records of all agreements with suppliers on terms and conditions of supply.
- (vii) Grocery retailers are required to provide to the body monitoring and enforcing the Groceries Code any information as it may reasonably require in pursuit of its functions, including the investigation of issues not the subject of the immediate dispute, and including complaints from primary producers.

8.21. The updated Groceries Code was designed to tackle the transfer of 'excessive risks and unexpected costs' from supermarkets to their suppliers. It was expected that it would limit large supermarkets' power to: (i) make suppliers change their supply chain procedures or pay marketing costs and compensation for wastage; (ii) make suppliers obtain goods or services from third parties who pay the supermarket for that arrangement; (iii) make suppliers pay supermarkets for stocking their products or pay for promotions; (iv) make suppliers pay for the costs of resolving disputes.

8.22. The U.K. Government introduced another Bill in the 2012/13 Parliament Session, the main elements of which are the creation of an Adjudicator whose role would be to ensure adherence to the Groceries Code. The Adjudicator would do this by arbitrating disputes between retailers and suppliers, investigating anonymous complaints and taking sanctions against retailers who break the rules. The Adjudicator would be responsible for upholding the principle of the Groceries Code suggested by the Competition Commission. It obliges large retailers (those with an annual groceries turnover in the U.K. of more than £1 billion) to deal fairly and lawfully with their suppliers and not vary supply agreements retrospectively, except in circumstances beyond the retailer's control which are clearly set out in the supply agreements. In addition, large retailers are obliged to pay suppliers within a reasonable time. The Adjudicator will also have the power to launch investigations into suspected breaches of the Groceries Code.

Conclusion and Recommendations

8.23. As noted in this report, the Council has received many complaints in the past from various parties, alleging anti-competitive conduct in the grocery sector. Some of these are illustrated in Chapter 6. The Council has in the past exchanged correspondence and held meetings with related parties in attempts to establish the veracity of the allegations. The allegations have ranged from attempts to induce resale price maintenance, raising rivals' costs and refusals to supply.

8.24. Now that Hong Kong has a competition law with an appropriate competition authority (Competition Commission) that has investigative powers, similar to those existing in other comparable advanced economies, the Competition Commission will have the power to activate information collecting powers and procedures to obtain the necessary evidence and therefore "reason to believe" or "reason to suspect" that a breach of law has occurred.

8.25. Moreover, because the Competition Commission will be in a better position to obtain information that could establish the veracity of allegations of anti-competitive conduct, one way or the other, to a high standard of proof, it will be able to clear the reputation of any grocery sector operator if it has been subjected to unfair innuendo and impulsive opinion. For example, in the complaints illustrated earlier in this report, there are serious prima facie competition issues that arise from the complaint against supermarket chains. A more rigorous examination of the allegations would be able to assess them to a higher standard than currently available, and clarify the extent to which there is any wrong doing.

8.26. The issues of concern in the sector are linked to the conduct of large players in the sector due to their alleged power in the marketplace, their roles as both competitors and commercial 'partner' to suppliers, and the arguably high concentration levels with regard to the market for 'one stop' shopping in Hong Kong. As the 'one-stop shopping' market in Hong Kong can be regarded as highly concentrated in terms of number of outlets and geographic presence in most areas, then the concerns that arise from oligopoly are also accordingly higher.

8.27. A question still remains as to whether 'secondary shopping' acts in a way to constrain the power of the supermarket chains in terms of 'one stop shopping'. However, on the face of the Council's findings in Chapter 3, and if the respondents views are to be accepted at face value, then it seems that there are not strong constraints on supermarket chains. If it is decided to pursue this issue further then detailed empirical research could be undertaken, for example measuring the extent of fluctuations in consumer demand in the face of small but significant increases in price by supermarkets.

8.28. Access by a grocery product supplier to a supermarket chain for distribution of its products is considered necessary for optimal market success. Therefore, if access to one of the major supermarket chains is foreclosed then suppliers will be unable to secure a satisfactory level of entry through dealing solely with other minor supermarket chains or other retail outlets for distribution of their products. This can be assumed to hinder the development of a vibrant grocery sector, and choices for consumers will be limited.

8.29. There have been numerous complaints across a broad spectrum of grocery products, with similar conduct being alleged, over a long period of time in the Hong Kong grocery sector. The cumulative effect of these disputes should arouse concern from a competition perspective. It is clear that the competition concerns that arise stem largely from the fact that the largest supermarket chains have a strong element of market power by virtue of

- (i) their strong buying power;
- (ii) the ease by which they can impose barriers to new entry;
- (iii) their vertical integration in the market as suppliers of 'own brand' products; and high market shares;
- (iv) their apparent heavy handed treatment of suppliers;
- (v) the seemingly arbitrary approach to pricing products in the marketplace and if correct, likely effect of that power on prices and product choices available to consumers.

8.30. It is noted that the supplier in one of the examples in Chapter 7 that made the complaint to the Government and the Council did so in the spirit of ensuring a fair business environment for Hong Kong, and with the intention that:

- (i) a relevant public body should investigate and follow up the matter;
- (ii) the public should be informed of the practice; and
- (iii) other suppliers should be forewarned.

8.31. The new Competition Commission is a relevant public body that should be able to follow up the complaints. However, some of the issues in the complaints are not necessarily matters that come within the Competition Ordinance since they are about whether parties in the sector are being treated unfairly, as distinct from being treated illegally. This dilemma is similar to what has transpired in the UK and Australia where ombudsman type roles have been considered to resolve disputes in the sector. As a result, residual questions remain in Hong Kong as to what action needs to be taken to resolve disputes about fairness that might arise in the future, notwithstanding the fact that a competition law and competition authority is in existence.

Self-Regulatory Model for Grocery Sector

8.32. The Council considers that it is in the interest of the trade and Hong Kong's business environment in general to consider whether some form of dispute resolution mechanism might be put in place to cater for future circumstances; given that complaints have been made in the past and will most likely continue. An answer could lay in examining the practicality of adopting the 'code of practice' approach used in Australia and the U.K.

8.33. The council is aware of the Code of Practices (Annex 8.1) of the Hong Kong Retail Management Association (HKRMA) for the supermarket sector in which it sets out framework of acceptable conduct to promote competition, thereby benefiting consumer welfare. The Code notes that the following practices should be adhered to by HKRMA members operating within the

supermarket sector:

- (i) All reasonable efforts will be made to ensure that the consumer is provided with the optimal value and choice possible within the current market environment.
- (ii) There will be no attempt to distort the normal operation of the market through any manipulation of pricing which may have the effect of restricting free trade or final consumer choice.
- (iii) No actions will be undertaken which may restrict the supply of goods or services that may in turn result in the restricting of free trade or final consumer choice.

8.34. However, information on the HKRMA web site does not contain any information concerning a complaint handling mechanism in support of its Code of Practices for the supermarket sector. Inquiries made with the HKRMA regarding how to make a complaint against one of its members indicates that complainants are required to make a written complaint and the HKRMA executive will deal with the matter on a case by case basis.

8.35. The Council suggests that the HKRMA code and a suitable complaints handling mechanism, constructed along the lines developed by the Council in its 'Fair Competition Rules – Reference for Industry Codes of Conduct', could form the framework of a suitable complaint handling mechanism similar to the Australian Model. Suppliers of the grocery market and other grocery retailers should be invited to join the scheme.

8.36. The Council's 'Fair Competition Rules' and associated documentation set out the necessary features of a complaints handling scheme, such as who has standing to make a complaint, the constitution of a committee, disciplinary provisions, information gathering powers, and transparency in the complaints handling process. Past discussions between the Council and complainants who are suppliers to the supermarkets have revealed a deep concern with making their concerns public. A major concern is with the detriments they might suffer in terms of exposing their commercial in confidence information to other industry participants who make up the membership of the HKRMA. To address these concerns, the dispute resolution mechanism could be contracted by the HKRMA to an independent third party that would administer the self-regulatory scheme at arm's length from the HKRMA.

8.37. While this study has not found strong evidence to substantiate any specific allegation of anticompetitive practices by supermarket chains, the Council urges the Commission to nevertheless look into the matters raised in the Council's investigation of complaints when the Competition Ordinance is fully implemented. Moreover, at the same time, some measures should also be taken to applying a form of redress to enable disaffected players in the sector to voice their concerns and have a fair hearing of their complaints. Concerns with conduct such as high-pressure tactics to influence the decisions of suppliers may still be considered unfair and problematic and therefore worthy

of being dealt with through an administrative process of redress for complainants (as found in other jurisdictions). A voluntary code regime, along the lines adopted in other jurisdictions should therefore still be considered to deal with fair trade contractual issues.

8.38. Applying a voluntary code regime in this way could also assist in alleviating some non-competition concerns that arise in relation to the actions of market participants who have substantial market power. There is an inherent value in the existence of an effective self regulatory code along the lines applied in other jurisdictions. The new Competition Commission should not be expected to deal with non-competition complaints and the existence of a forum where trade complaints that are 'fringe' competition complaints could be heard would free up the Commission's resources to tackle other issues. As such, a Code of Practice for the supermarket sector would be an important adjunct to competition law; as is apparently the case in the Australia.

8.39. As a first step, the development of an effective competition complaint forum within the HKRMA, that is acceptable to all sides in the grocery sector, could be a major and welcome initiative. If the market has confidence in the self-regulatory model adopted by the HKRMA for complaints handling, this might suffice without any further need for government intervention except of course where there is a clear indication of a contravention of the competition provisions in the Competition Ordinance.

8.40. Although an industry self-regulatory model eventually developed for Hong Kong might not be as effective as the British mandatory model, which has some form of protection from commercial retaliation for making complaints about breaching the Code, it could still provide benefits. Primarily, it could serve as a channel for the trade to develop mutually agreed business practices to facilitate economic efficiency in the grocery market and prevent government over-intervention on allegations of unfair practices between parties which have no effect on public interest. If at some later stage the self-regulatory model is not able to address those unfair trade practices with direct adverse effects on consumers, then the government could consider whether it is necessary to adopt the British mandatory model, to address unfair trade practices in the sector, or to amend the Competition Ordinance to deal with the problems.

Preventive Measures

8.41. With a cross-sector competition law currently in place in Hong Kong, there are restraints on certain forms of anticompetitive conduct, as provided in the law. However, it is noted with some concern, that a mergers and acquisitions provision does not form part of the law, apart from the telecommunication sector. Any attempted acquisitions by supermarket incumbents of assets that deny new entrants an opportunity to either enter the market, or increase their presence, will therefore be excluded from preventative action by the Competition Commission.

8.42. In this regard, the Council notes that the Government has undertaken to review the Competition Ordinance a few years after the full implementation of

the Ordinance. The Council urges the Government to consider (in that review) the introduction of a cross-sector merger control regime so that the Commission would have oversight where a merger of acquisition might arise that may have a detrimental effect on public interest. In particular the Council considers that the Government should be in a position to act quickly, as a preventative measure, if there is a merger between incumbent supermarket chains or an acquisition by any competitors of strategic assets that would impede new entry. Similar preventative regulatory action exists in other competition law jurisdictions. So far, the power available to the Competition Commission would only be to express a concern with possible detriments in the market but it would not be able to reverse or prevent the continuation of accumulation of market power.

8.43. Finally, the Council stresses that the Government should be aware of a trend in the diminishing number of single grocery outlet operators and their weakness in the marketplace in terms of providing competition with supermarket chains. While there are some smaller supermarket chains, and there are other chain stores providing specialized, as distinct from 'one stop' shopping it is unclear as to how strong they are in challenging the major chains pricing and supply decisions. It is important to recognize that an increasing concentration in the number of supermarket chains in the market will not enhance vibrant business development in the grocery sector.

Annex 8.1**Hong Kong Retail Management Association
Code of Practices for the Supermarket Sector
Sector-specific self- regulation of restrictive practices**

In compliance with the HK Government's guidelines on restrictive practices as listed in the Statement on Competition Policy, the Supermarket Sector employs a Self-Regulated Code of Practices to Promote Competition, thereby benefiting consumer welfare.

The following practices should be adhered to by HKRMA members operating within the supermarket sector:

1. All reasonable efforts will be made to ensure that the consumer is provided with the optimal value and choice possible within the current market environment.
2. There will be no attempt to distort the normal operation of the market through any manipulation of pricing which may have the effect of restricting free trade or final consumer choice.
3. No actions will be undertaken which may restrict the supply of goods or services that may in turn result in the restricting of free trade or final consumer choice.
4. No agreement will be undertaken to divide or share any market based on geographical or socio economic basis which may have the result of restricting free trade or final consumer choice.
5. There will be no attempt to implement unfair or discriminatory standards with the purpose of denying any potential newcomers access to the market place.
6. There will be no discriminatory deprivation of supply or choice which may have the effect of restricting free trade or final consumer choice.
7. There will be no setting of artificial retail price minimums for products where there are no ready substitutes.
8. There will be no rental bid rigging that leads to lower rents than would be available under normal operation of the property market.
9. We will look to develop long term sustainable business relationships with all suppliers with the joint objective of providing optimal choice and value to the final consumer.
10. We commit to being both open and transparent in all dealings with all existing & potential suppliers.

11. No attempt will be made to mislead the customer by falsified advertising. We commit to ensuring that all press and TV advertising is an accurate reflection of in store pricing.
12. We commit to take a proactive approach in all managing all consumers' concerns and will provide timely and accurate responses to these concerns where necessary.

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