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Below Cost Legislation: Lessons from the Republic of Ireland

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Abstract. This paper traces the emergence, evolution, and demise of below cost legislation in the grocery industry in the republic of Ireland. The paper adds to our understanding of the legislation by adopting the view that, by using the net invoice price as its definition of cost, the legislation increased two streams of quasi-rents, first on suppliers' brandeds and second on retailers' own brands which acted to depress competitive forces and direct supplier-buyer negotiations to off-invoice discounts. Supplier generated quasi-rents financed discounts, and when coupled with retailers' higher margins on their own brands, provided little incentive for a return to a price competitive environment. Two factors undermined this situation: the substitution of discounters' products for suppliers' brands as the discounters share of the market grew and the increase in cross border shopping. These had the combined effect of reducing the available quasi-rents earned in the Irish market resulting in the breakdown of the status quo and a return to price competition.

Through its impact on negotiations, the legislation also introduced inefficiencies to both retailers' and suppliers businesses representing additional waste that could have been more productively used to reduce consumer prices. The paper endorses the Government's decision to rescind the order and remove an important constraint on both vertical and horizontal competition. Lessons from the Republic of Ireland suggest that the competitive response to the removal of below cost legislation, and reductions in prices, may take time and will depend on economic circumstances and a change in the prevailing norms of organizational behaviour and quasi-rent seeking opportunities.

Keywords: Grocery market, Below cost legislation, off-invoice discounts, quasi rents.

Introduction

Given the frequency of purchase, and their share of household expenditure, the prices of grocery products act as a significant determinant of a household's welfare. Competition between retailers in the grocery market should, at least in theory, lead to lower prices and other value gains for customers. One way of lowering prices is for retailers to offer price based promotions, which may include selling some items below cost (the purchase price from suppliers), for a set period of time. It is commonly felt however that below cost selling is "unfair" and will ultimately disrupt the structure and power relationships within a market, to the detriment of weaker stakeholders. The outcome of any

restriction on below cost selling is a form of retail price maintenance, yet despite the widespread criticisms of RPM (eg Yamey 1966), the prohibition of such practices are a common feature of public policy in retailing. For example, in 1997 the Galland Act which came into force in France prevented retailers from selling below the invoice price (Colla 2006), and other restrictions on grocery pricing apply in Belgium, Luxembourg, Portugal, Italy, and Spain (Colla and Lapoule 2008). Like most public policy interventions in the retail sector, below cost legislation is primarily driven by a desire to prevent perceived distortions to both horizontal and vertical competition, and their consequent impacts upon less powerful stakeholders. Colla (2006) suggests that the rationale for this type of legislation is twofold. First to prevent predatory pricing, where a retailer may resell a product below cost to drive out weaker competition or discourage market entry; and second to prevent below cost selling from damaging the manufacturer's sunk cost investments in brand value.

This paper traces the emergence and the debate surrounding the evolution of below cost legislation, the Grocery Order (1987), in the Republic of Ireland. The impact of the legislation on grocery prices in Ireland has been already been investigated (Collins et al 2001). This paper will trace the steps that led to the introduction of the legislation in 1987 and the emergence of a definition of below cost that was to result in unintended yet anticipated behavioural responses that served to: limit the downward pressure on grocery prices; introduce inefficiencies in both retail and supplier organisations; and stifle sourcing innovation. It builds on the work of Collins (2008) by adopting a quasi rent seeking approach to explain the initial stability in pricing arrangements with the retailer-supplier dyad followed by its rapid demise in 2009. Interviews with current and former buyers from the three main grocery buying organisations in the Republic of Ireland inform the debate.

Defining Below Cost : cost versus price

The sale of some products below cost, often referred to as "loss leading", is seen as an integral part of marketing policy for many grocery retailers. The commercial argument for this practice stems from a desire or a need to match the price offers of competitors at

a local or national level, to maintain price differentiation from competitors to secure a market brand position, or to honour price pledges made as part of the company's commercial strategy. Additionally, the practice is seen as a legitimate means to generate customer traffic into stores at traditionally quiet trading periods, to dispose of excess stock, or to support the launch of a new product.. In the UK, the Competition Commission examined below cost selling within nine grocery chains between January 2005 and June 2006 as part of their investigation into supermarket retailing. Over this period below cost selling – across both national and private brand products – accounted for 3% of total revenues, and on average these products were sold at prices 11.9% below cost. Despite the prevalence of below cost selling, it is however generally viewed as an undesirable strategy by public policy agents, which can lead to market distortions and therefore requires some form of regulation to prevent loss leading becoming predatory pricing (Competition Commission 2008).

By definition below cost legislation requires the determination of cost. However the term "cost" is not as clear as it might initially appear and this can generate complications for the way in which legislation is framed and implemented, and for the behaviours it induces among businesses. In particular, it is necessary to consider the distinction between cost and "net invoice price". For the purpose of clarity at this stage we shall ignore taxes. The cost a retailer incurs in selling a product is made up of two components. The first component is the amount of money paid to the supplier of the product. This in turn can be broken down into two elements. The first element is the price on the invoice which may contain discounts based on the size of the order or other economies associated with the transaction. This may be termed the net invoice price. The difference between the retail price of the product and this cost yields the product's gross margin. The second element, sometimes referred to as supplementary terms, may involve a range of incentives and usually take the form of rebates paid to the retailer based on future performance for example achieving certain sales targets. To determine the true "cost" of the product these supplementary terms should be added to the gross margin, yielding an adjusted gross margin. Deducting the supplementary terms from the net invoice price yields the real price paid by the retailer.

Ideally, any definition of below-cost used in regulating the grocery sector would equate to this latter figure, the real price paid by the retailer. However calculating the real price (or cost) is problematic caused in the first instance by time and the second by scope. In the case of time, the monetary amount of the supplementary terms is unknown at the time of the sale. While an agreed formula may, after a process of negotiation, exist for calculating the amount of the rebate (e.g. X% of sales) the precise amount of money to be paid to the retailer will not. Further ex-post difficulties arise because of scope and the fact that supplementary terms are usually paid on the totality of business done with a supplier over a period of time. In general this is not product specific as many suppliers deal with multiple products and indeed multiple categories. Consequently, apportioning the supplementary terms to individual products would, if attempted, be based on a set of company specific underlying assumptions or rules.

As far as below cost legislation is concerned, therefore, it is usually not possible to calculate the real price paid by a retailer to a supplier for a specific product at the time of invoice. This fundamental problem of identifying a real price or cost has significant implications for the implementation of below cost legislation. The introduction of the Galland Act in France, and its implications for firm behaviour as recounted by Colla (2006) and Colla and Lapoule (2007) provides a clear illustration of this problem. Following extensive lobbying from the small retailer and manufacturer constituencies, the Loi Galland was approved on 1st July 1996 amending previous below cost legislation dating back to 1963 and 1986. As an integral part of the legislation the distinction between the net invoice price and the supplementary terms, known as "marges arriére" (or back margins) was recognized, and two separate invoices were required in order to improve price transparency. The list price - as far as identifying below cost was concerned - was taken as the first of these two invoices ie the net invoice price, excluding supplementary terms. The immediate impact of this approach was a reduction in price competition in the French market through the standardization of retail prices and intra-brand and intra-store competition, and a switch in focus during negotiations to back margins, which somewhat perversely helped to improve the retailer's margin but could not be passed on to consumers in the form of lower prices. Over time the legislation is believed to have encouraged

grocery price inflation, improved the competitive position of those selling private brands (including hard discounters) and stimulated new promotional initiatives, such as discounts on the total value of the shopping basket as opposed to individual items. Revisions to the law in July 2005 (Dutreil Act) and December 2007 (Chatel Act) progressively allowed retailers to deduct increased proportions of back margins from the net invoice price thus lowering the net invoice price and providing some flexibility in pricing.

There are certain parallels between the French and the Irish experience which we will explore below. We shall see that attempts to frame the legislation to capture the "real price" (inclusive of all discounts) were problematical and that as in France a more easily identifiable measure, the "net invoice cost" which excluded all off invoice discounts, was to be used with similar undesirable outcomes in terms of consumer prices and retail buyer behaviour.

The Emergence of the Groceries Order

The 1956 Groceries Order was the first attempt to regulate trading relationships within the grocery sector in the Republic of Ireland. The Order emerged in response to changes in the distribution of grocery products and the structure of the grocery supply chain. In overall terms the extent of price competition at the time was limited; the practice of Resale Price Maintenance (RPM) was ubiquitous with most prices being specified by the manufacturer or supplier either through price marking, advertising, or direct instruction. The Fair Trade Commission's (FTC) enquiry into the grocery trade during 1955 was very progressive for the time in concluding that the extent of price competition in the grocery trade should be stimulated to the benefit of the consumer. The legislature responded positively to the FTC's recommendations and the resultant 1956 Groceries Order heralded in a new era in the grocery sector. Amongst other practices, the Order prohibited resale price maintenance and collective price fixing throughout the grocery channel. However, even then, the practice of below cost selling was considered as undesirable and manufacturers and suppliers were permitted to withhold supplies in cases where a retailer sold a product at a price that was below wholesale cost before the deduction of quantity discounts.

By 1972 the structure of the industry had changed significantly. The multiple retailers' bargaining power had increased noticeably and was such that they could now negotiate terms on a par with wholesalers. This was despite the fact that manufacturers and suppliers incurred higher costs when distributing directly to individual retail stores. Also, multiple grocers were negotiating supplementary terms over and above those justified by economies of order size (FTC 1972). There was also evidence of an increasing use of below cost selling which was usually combined with intensive advertising by the retailer to encourage customer traffic. Despite the fact that manufacturers possessed the right to withhold supplies under these conditions, and indeed were frequently encouraged to do so by certain sectors of the grocery trade, they rarely did. Suppliers clearly disliked the practice of below cost selling but the increasing availability of low priced generic private label products and the fear that the larger retailers would simply source supplies elsewhere conditioned their responses. Multiple retailers' power had increased to the extent that the existing sanctions designed to counter undesirable trading practices were proving ineffective.

One of the more interesting features to emerge from the Fair Trade Commission's (1972) deliberations concerned a possible prohibition on below cost selling. But, even then, the Commission recognised and highlighted the insuperable difficulties associated with regulating retail prices on the basis of a price paid by the retailer to a supplier when such a price could be partly determined by future discounts. The commission also warned that any ban on below cost selling would diminish competitive forces and recommended that a ban on below cost *advertising* should be introduced. Their view was that widespread advertising of below cost prices might generate a misleading impression of large retailers' overall price levels (Massey and O'Hare, 1996)and that a ban on advertising would also restrict the benefits of below cost selling and reduce its incidence. This was duly incorporated into the 1973 amendment of the Groceries Order with an important variation. The Fair Trade Commission (1972) recommended a ban on below cost advertising where cost would be defined as net purchase price. Net purchase price would include tax but no reference was made to future rebates (FTC 1972: 225). In the 1973 Order it was stated that the retailer should not advertise at a price which was less than the price after the deduction

of any discount (Department of Enterprise, Trade and Employment 2005). How such a price was to be calculated was not specified and was likely to be problematic given our earlier discussion.

The definition of below cost was finally clarified in 1978, when the Restrictive Practices Commission recommended that cost be equated to net invoice price plus value added tax. This was clarified in the high court in 1979 in a case between Tesco and RGDATA and the Irish Association of Distributive Trades Ltd (IADT). Tesco had been advertising below cost, and acknowledged this behaviour, but argued that future rebates should be considered in the calculation of cost. The legal judgment however ruled that the net invoice price could not be equated with the real price which would depend on the size of future rebates. The implications of this judgment were far reaching: for the purposes of the Groceries Order, net invoice price excluded off-invoice discounts. Any remaining doubt was removed with the addition of this definition to the 1981 Groceries Order.

The Prohibition of Below Cost Selling

It is notable that even at this stage, there was no legally enforced prohibition against below cost selling. In its 1980 review of the grocery trade, the Restrictive Practices Commission maintained the view that the prohibition on below cost advertising was sufficient and that a ban on below cost selling was not justified. However there was mounting evidence that increasing competition among the multiple retailers was leading to widespread below cost selling (Yates 1984). By 1986 the matter had reached a stage where the then Minister for Industry and Commerce requested that the Restrictive Practices Commission explicitly investigate and review the issue of below cost selling. In its report, the Restrictive Practices Commission (1987) recommended a ban on below cost selling for four reasons. First, and most importantly, it was clear that the prohibition on below cost advertising was not proving effective in reducing the extent of below cost selling. Second, the multiple retailers' share of the market continued to grow and was believed to threaten the viability of the independent sector. The top three multiple operators had increased their market share from 44.4% in 1983 to over 56.1% by the end of 1987 (Table 1). Third, the manufacturers' practice of providing additional allowances to retailers as an incentive not

to sell below cost demonstrated the growing power of the multiple retailers within their relationship with suppliers. These allowances were considered undesirable and discriminatory with a distoring effect on competition and were felt to threaten the viability of the independent sector. Fourth, below cost selling led to inefficiencies in production and stockholding among suppliers. It also raised tensions with other retail customers who requested price reductions to enable them match the prices of those retailers engaged in below cost selling.

Table 1. Concentration in the Grocery Market: Market Share by Company, 1983 and 1987

Retailer	Dec 1983	Dec 1987
Dunnes Stores	17.4	25.4
Power Supermarkets	18.5	24.5
SuperQuinn	6.6	6.2
Tesco	8.4	0.0
Multiples (CR3)[1]	44.3	56.1
SuperValu[2]	6.3	7.0
Total (CR3)	44.3	56.9
Total (CR4)	50.9	63.1

Source: Taylor Nelson AGB.

Multiple (CR3) refers to the share of trade attributable to the three largest multiple groups. Total (CR3) refers to the share of trade attributable to the largest 3 buying organisations including SuperValu. SuperValu stores are independently owned but trade under a wholesaler controlled trading fascia.

The Commission's recommendation, that there should be a ban on below cost selling, based on the view that the practice was "*intrinsically unfair*", was incorporated into the Groceries Order 1987 and came into force in December 1987. Below cost was defined in terms of net invoice cost including value added tax. That this could lead to a form of resale price maintenance was recognised but the view taken was that competition would depress invoice prices (RPC 1987:49). The ban was to cover grocery goods, defined as:

"goods for human consumption (excluding fresh fruit, fresh vegetables, fresh and frozen meat, fresh and frozen fish which has undergone no processing other than freezing with or without preservatives) and intoxicating liquors not for consumption on the premises and such household necessaries (other than foodstuffs) as are ordinarily sold in grocery shops

and includes grocery goods designated as 'own label', 'generic' or other similar description" (SI No 142 of 1987).

The term "household necessaries" opened up considerable scope to avoid prosecution. For example, over the years products such as light bulbs and disposable nappies were found to lie outside the scope of this definition (Department of Enterprise Trade and Employment 2005; 115)

In summary, the prohibition of below cost selling was introduced largely as a result of increasing retailer concentration and buying power, the demise of the independent sector and the *"views of manufacturers and retailers that it would make a significant difference to them"*. On the consumers' side, one argument presented in favour of the ban was that it would:

"seem likely that a wider range of products would be sold at cost or just above cost as a substitute for below cost selling so that there would be no net additional cost bearable by the consumer" (Restrictive Practices Commission 1987).

However, there were problems with the legislation. The first concerned unintended consequences and the behavioural responses within the trade. The RPC (1987) acknowledged a weakness that all discounts, rebates, allowances, and long term agreements (LTAs) did not appear on the invoice. Despite this, they took the view that competition among retailers would result in these supplementary terms appearing on the invoice and that market forces would ensure that the net invoice price would equate to the real price of the products. By 1991, in its review of the 1987 Order, the Fair Trade Commission[1] recognised that there were difficulties. The Commission in its 1987 report had recognised that by defining cost in terms of net invoice price there was the potential for suppliers to re-introduce a form of resale price maintenance through the use of off-invoice discounts. By 1991 it was becoming apparent that both the frequency and magnitude of off-invoice discounts (up to 25-30%) had increased considerably (FTC 1991).

By removing discounts from invoices, suppliers could in effect raise the minimum retail price, thereby dampening the extent of price competition at the retail stage of the channel.

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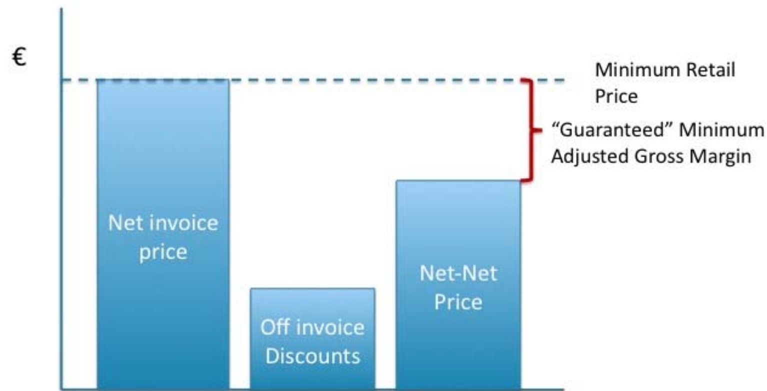
[1] The Restrictive Practices Commission was renamed the Fair Trade Commission in 1987.

This is demonstrated in figure 1. This had an interesting effect on the bargaining processes between retailers and their suppliers. If retailers believed that a common net-invoice price was being paid throughout the trade, they had an incentive to negotiate for larger off-invoice discounts instead of negotiating for lower net invoice prices. It also made negotiating price increases easier for suppliers. With the minimum market price being determined by the supplier, the off-invoice discount became a quasi-guaranteed minimum adjusted gross margin. In addition to causing retail prices to be higher than they might ordinarily be, this opened up the clear possibility of substantial discrimination among retail customers, which could threaten the competitive structure of the industry. A consequence that the legislation had intended to prevent! As Grant (1987) proposed, the "*principal effect of buying power is not to depress prices across markets but rather to induce price discrimination in favour of large buyers through discounts*".

In spite of the growing evidence, the three members of the 1991 Commission did not arrive at a unanimous view on the need to revoke the ban on below selling (FTC 1991). The majority view held that the ban was a serious restriction on competition and that, due to off invoice discounts, minimum resale prices were higher than they would be without the ban. The Commission was also unanimous in its view that net invoice price was an unsatisfactory definition of cost. However, no further changes were made to the 1987 Groceries Order until 2006.

Figure 1.

The Relationship between Net Invoice Price, Off Invoice Discounts, and Minimum "Guaranteed" Adjusted Gross Margins



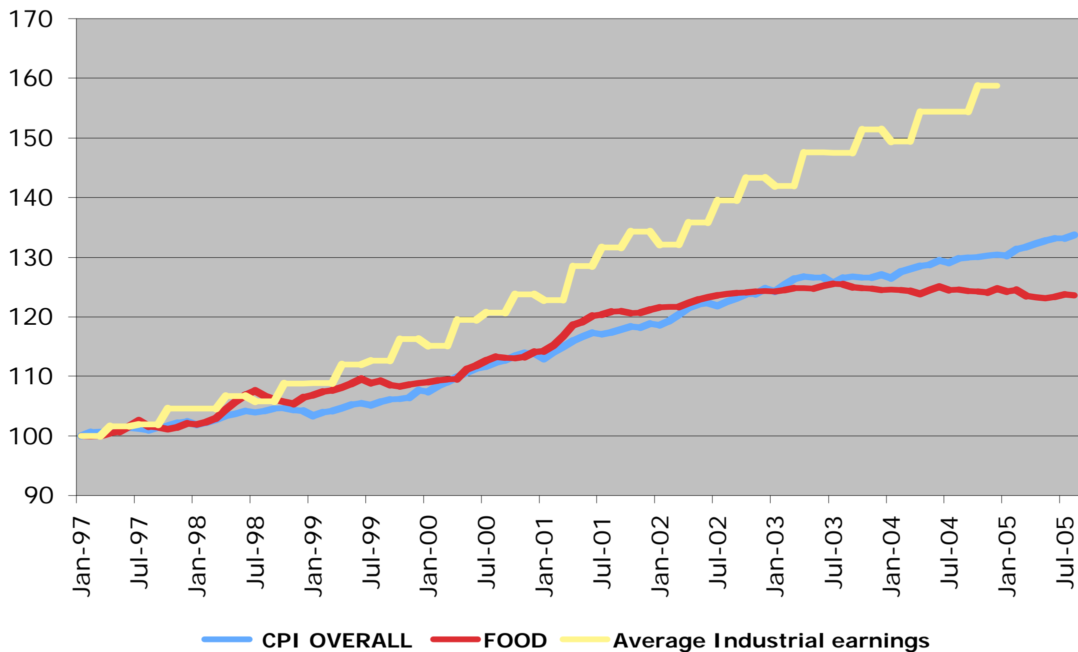
Turning Tides : the changing environmental context

Given these behaviours, it is not surprising that a considerable degree of uncertainty surrounded the continuing existence of the Order. Grocery trade associations, manufacturers and producers all exercised strenuous lobbying activities for the retention of the Order. It appears that at one stage the Consumer Association of Ireland also supported the retention of the Order and the ban on below cost selling (Department of Enterprise Trade and Employment 2000). Even though the failings in the legislation had been apparent for so long, the evidence suggests that there was no clear political motivation for change.

To understand the lack of appetite for change it is worth considering the unfolding economic and commercial environment. From the mid 1990's the Irish economy was about to enjoy a decade of unprecedented growth. While overall inflation and food price inflation were increasing, average industrial earnings were growing at a faster rate (fig 2). Consequently, it is proposed that grocery prices were not a major issue for consumers at the time. Shoppers' increasing affluence was also reflected in the product mix developed

by retailers. The move to premium type products was clearly in evidence with high quality premium private brands developed by all the main retailers.

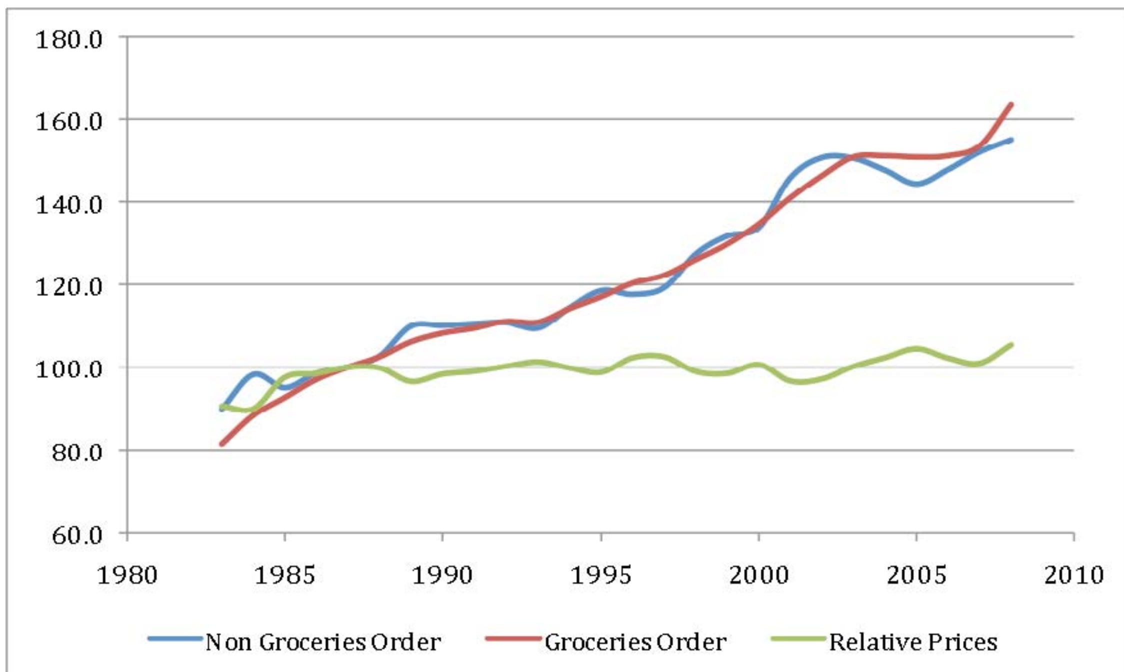
Figure 2. Earnings Growth and Inflation in the Republic of Ireland



Source: CSO

Despite the difficulties in actually determining the precise product coverage of the Order it was held that approximately 75 percent of the typical basket was subject to the Order. Many arguments focused on the change in relative prices between those products covered by the Order and those products that were not subject to its provisions. This data is provided in figure 3. The lack of evidence supporting a clear and consistent divergence in both price series was used by proponents in favour of maintaining the Order as a sign that the Order was not suppressing competitive forces. On the other hand, periodic differentials in price inflation could be used to suit the case of a particular lobby or interested party at a point in time (e.g. Consumer Stratey Group 2005;59).

Figure 3. Price Indices for Grocery Order and Non Grocery Products
Base 1987=100



Source: CSO

This was about to change however. In 2004 the then Minister for Enterprise, Trade and Employment established the Consumer Strategy Group which reported on the grocery trade (CSG, 2005). Central to the group's critique of the grocery market was the extent of off-invoice discounts. It stated, without providing any supporting evidence, that these discounts amounted to an average of 18 percent for the largest retailers (CSG 2005;80). Given the terms of the legislation, with its focus on net invoice price, these discounts could not be passed on to shoppers as lower prices. This figure received considerable attention in the media and was reported extensively. It was suggested that if prices were to fall by the amount of the off-invoice discounts, the typical household could save up to €1,000 per annum. The Groceries Order was subjected to ridicule when one large retailer sold disposable nappies below the net invoice price. The Director for Consumer Affairs, who had responsibility for enforcing the Order, took the retailer to court. The retailer did not contest that it had sold the products below net invoice price but rather argued that

disposable nappies were not a household necessary and consequently were not subject to the Order. The retailer won its case!

Other factors also began to emerge. Food inflation in Ireland was considerably higher that UK inflation. This is despite the fact that Tesco was both the Republic of Ireland's and the UK's largest retailer. One frequently used argument to support this difference was that the costs of doing business in the Republic were considerably higher and explained the difference in prices. However, as pointed out by the Department of Enterprise Trade and Employment (2005), no such price differentials existed in clothing, suggesting that the dynamics of competition in the Irish grocery market were not operating to the consumer's best interests. This made it increasingly difficult for the previously successful lobby groups who argued for the Order's retention.

On the supply side, the competitive capacity in the Irish Market was also starting to increase over this period. Tesco had re-entered the Republic of Ireland in 1997 by purchasing the Power Supermarkets chain of stores[2]. This chain held approximately 25% of the market and Tesco's purchase brought a new dimension to the competitive environment. In particular, the fact that its British arm had a private brand participation in the region of 50% compared with 15% in Power Supermarkets opened up the possibility of a radically new supply chain model, with imported products displacing Irish sourced products. To allay these concerns Tesco gave the Irish government a series of undertakings:

"*such as to have a buying office in Ireland, to enhance the amount of resources the company puts into working with Irish suppliers to ensure that they, in turn, can increase the volume of sales in the Irish market. Tesco has agreed to bench-mark those commitments and agreed to their regular auditing, to ensure demonstrable progress in increasing sales of Irish suppliers"*[3].

It should be recognised that Irish sourced products could also include international branded products distributed by Irish agents, wholesalers or local ancillary offices. Tesco also committed itself to honouring the legal obligations as set out in the Groceries Order.

Further developments ensued. Aldi and Lidl, the German limited line discounters arrived in the late 1990's and early 2000's. Rather than entering by acquisition, these companies followed an organic growth strategy, purchasing and developing their own sites. As a consequence, the supply chain models they adopted were not scrutinised to the same extent as Tesco's had been, nor were similar commitments to the local supplier base demanded. Also, their business strategy was based almost entirely on private brand products most of which were sourced abroad. Finally, consolidation of the independent sector continued with independent multiple chains such as L&N, Roches Stores, and Pettits either being sold to or entering into franchise agreements with Musgrave, the country's largest wholesaler.

[2] Most of the stores traded under the Quinnsworth name and a few under Crazy Prices.
[3] Dail Eireann – volume 478 – 22 April 1997 Priority Questions – Supermarket takeover

Cullen Paul (2009) Tesco's high prices a strategy to meet profit targets. Irish Times May 12

Over the 2000-2009 period, the number of primary destination grocery stores had increased by 73 percent. The significant inflow of new capacity pointed to a profitable industry.

Table 2 Store Numbers in Ireland among Major Retailers

	1997	2000	2006	2009	% Change 2000-09
Tesco	78	76	91	116	53
Dunnes Stores	54	62	90	97	56
Superquinn	16	17	20	23	35
Supervalu	166	172	178	191	11
Aldi	0	8	40	65	712
Lidl	0	16	82	115	618
Total	314	351	501	607	73
Source: Company Websites and Communications, Submissions to the Joi Committee on Enterprise and Small Business; IGD retail analysis					

All in all, these economic and market changes meant that the justification for the Groceries Order was being systematically undermined and finally the Order and the ban on below cost selling was revoked on March 11th 2006. The over-riding view was that the ban on below cost selling, defined as selling below net invoice price, imposed a form of resale price maintenance. Even if they had wanted to, retailers could not pass on the off-invoice discounts they received from their suppliers to their customers and consequently it forced prices to be higher than they necessarily had to be. At the same time low price private brand driven retailers had entered the market with a business model that for the most part was unaffected by the legislation.

Quasi Rents and Changing Buyer Behaviours

This section draws on the concept of quasi rent to explain some of the observed behaviours in the Irish grocery market. In particular, it seeks to address two key questions; 1) why did retailers not seek to force down net invoice prices to compete on price and 2) what exogenous changes occurred that led to a resumption of price competition during 2009? To address these matters, first the resources that generate quasi-rents have to be identified and second the distribution of bargaining power between retailers and suppliers to retain or appropriate these rents needs to be considered (Coff, 1999). The arguments outlined draw on a series of interviews with three senior buyers from the three largest buying entities in the country. The buyers were selected on the basis of their experience of working with more than one retailer or wholesaler and had experience of working in categories covered by the Order. Two of the buyers had experience of both the multiple and independent sectors. One of the buyers although still working in the industry was no longer a buyer or employed directly by a retail or wholesale business. The inteviewees were informed of the purpose of the interviews and that the research was to add to already completed research during the earlier part of the decade (Collins, Oustapassidis and Burt , 2001). Key informant bias suffers the risk of serious flaws resulting from key informant prejudices and in this case, over or under reporting the phenomenon. In particular the risk of attributing causal behaviours to different channel members had to be considered. To redress these risks responsdents were encouraged to use their experience and observations of the different companies they had worked for and categories they were responsible for. Moreover, the interviews were held during the first half of 2009 almost three years since the repeal of the Groceries Order with the result that the respondents were more comfortable discussing the matter, and likely to be less prone to bias than they might have been while the Order was in operation.

The ability to set a net invoice price across the industry provided an efficient means of suppressing price competition at the retail stage of the channel should the net invoice price be uncontested. It provided suppliers with the ability to generate increased quasi-

rents on their brands. Quasi-rents differ from rents in that they are measured as the proportion of earnings, in this case to the brand, in excess of the minimum required to keep it from exiting its industry (Milgrom and Roberts 1992) or in this case a particular retail account. Once generated, these quasi-rents became subject to bargaining processes and could be appropriated by retailers in the form of off-invoice discounts. These appropriated rents provided retailers with one incentive to forego lower net invoice prices. The size of the quasi rents pool would be critical to maintaining high and uncontested net invoice prices. It had to be sufficiently large to support the existing vertical equilibrium (Peltzman et al 1989).

Retailers and large wholesalers could be confident of their bargaining power. Collins (2002) found that retailer concentration was positively related to retailers' bargaining power. The consolidation of the independent sector and the emergence of strong wholesalers (e.g. Musgrave supplied over 20% of the grocery market) meant that a previously fragmented market could now operate as one. Tesco held approximately 25% of the market and also had the ability to source international brands from the UK should relations in the Republic breakdown. Dunnes Stores held over 23% of the market.

Second, retailers bargaining power was strengthened by their access to relevant information. Through their knowledge of volumes sold, product costs, and indeed invoice prices paid by their international operations, the larger retailers and wholesalers would have had an accurate understanding of the size of the quasi rents being generated by brands sold through their businesses, providing them with a benchmark when negotiating off-invoice discounts. With this knowledge, retailers would be expected to expend considerable efforts in appropriating as much of the available quasi rents as possible during their discount negotiations.

Throughout the 1990's it is clear that the suppliers of those category dominating branded products covered by the Groceries Order played an important role in determining the extent of price copetition among retailers. The dynamics of negotiations across fresh (not covered by the Order) and dry grocery (covered by the Order) products differed

substantially. Fresh buyers focused on lowering suppliers' prices and enhancing promotional activity, while grocery buyers focued on appropriating quasi rents.

*" we(in Fresh) were always driving it. We had the best promotions and the best marketing and the grocery crowd did nothing as far as we were concerend because they were completely dominated by **** (international branded supplier name ommited) and everybody else… We thought they (dry grocery buyers) did absolutely nothing, because not alone did they tell them what to do, they gave them their margin. The only big issue they had was once a year with the LTAs. That was their big moment".* (Buyer 1).

The effect of the legislation on negotiations, particularly with the large branded suppliers emerged. Emphasis was on the LTA. The invoice price was treated as a given but this actually suited retailers as it insulated them from the risks of a price war and protected their turnover.

""**** (Brand name omitted) was the same price everywhere. Whether it was Quinnsworth, Dunnnes wherever. And the invoice price to everybody would be the same but the LTA (long term agreement) would be varied. So the way you negotiated with *** (Bband name supplier omitted) was not on the invoice price or the retail…They could give you an invoice price that we all had to honour and it suited the retailer now. You knew that was the only price that could be there. Technically then there couldn't be a price war. It was all about the LTA. On those negotiations it was all about the LTA." (Buyer 1).

The structure of LTA deals was highly complex. Discounts mentioned in our interviews with buyers included distribution discounts, promotional discounts, settlement discounts, discounts for joint business planning and marketing, incentive based discounts, and harmonisation discounts. Furthermore, once the buyer had exhausted all of the existing discounts.

"*you became creative and came up with whatever bucket you could"*. This was made possible because "*when you had growth, things were easier to get"* (buyer 3).

Appropriating the quasi rents was not easy or costless. Negotiating deals was a lengthy and involved process. With multiple category suppliers, teams of six or seven from each side would often be involved and the negotiations could go on for months. Sometimes negotiations would be escalated to the very top of the management hierarchy and, if they were not resolved to the satisfaction of the retailer, a supplier's products could be withdrawn. The extent to which these negotiations evolved and dominated the business

was put succinctly by one buyer who said "*LTAs had grown into a monster*" (buyer 2). They generated considerable inefficiencies and because of the complexity of deals, *"deal checking had become a little industry in itself"* (buyer 3) using up resources that in other circumstances could have been passed on to consumers through lower prices.

In addition to the off-invoice discounts, there was another stream of benefits accruing to retailers. Through their influence on net invoice prices of the major branded products, suppliers also indirectly influenced the price of retailers' own brand products. The leading manufacturer brand on the national market (which could be an international brand) effectively set the price for own brands, from which a price differential of at least 10% initially applied. Higher net invoice prices on branded products facilitated higher retail prices and consequently higher quasi rents on the retailers' own brands. While higher prices would have been expected to reduce demand, the ongoing growth in the Irish economy ensured that volumes demanded continues to rise. This in turn influenced the flow of quasi rents earned on these products, improving retail margins and providing a further rationale for the continuation of the status quo.

The availability of quasi rents on leading manufacturers' brands in the Irish market and the associated complexity of the deals introduced rigidities into the evolution of the supply chain, favouring the use of the domestic supply chain over international sourcing even in the case of international brands. This was despite the fact that the top three grocery interests had businesses outside the Republic of Ireland. The use and complexity of off invoice discounts, and their effect on minimum retail prices and quasi rents, meant that locally negotiated deals could yield better returns for retailers than those negotiated overseas.

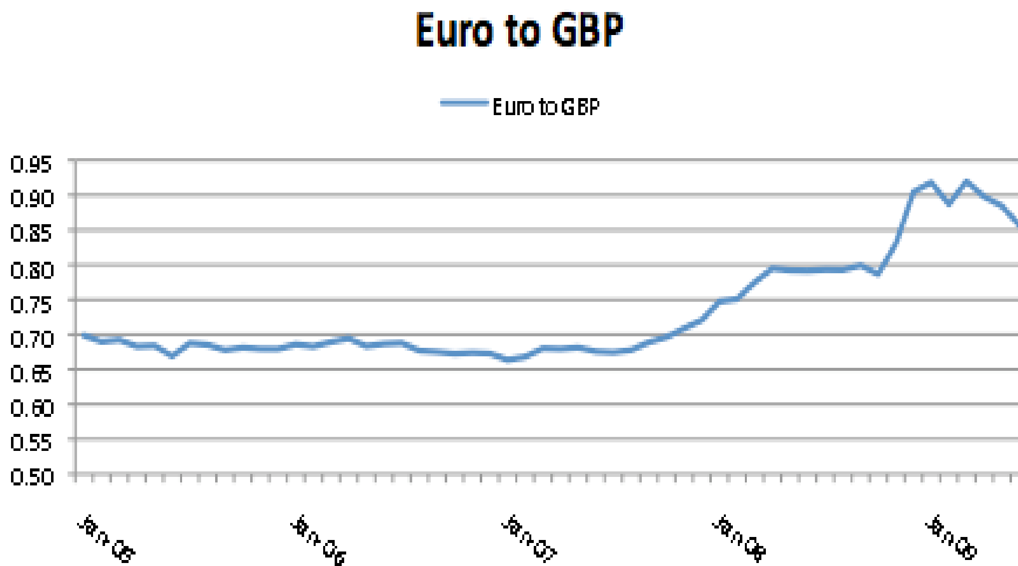
It is noteworthy, that the abolition in the Groceries Order in 2006 did not result in the anticipated increase in broad based price competition. Food prices in general did not fall and indeed continued to rise. Figures obtained by the Irish Times from an internal Tesco Ireland marketing plan revealed profit margins of 9.3% for 2008, 50% higher than those achieved in the UK (6.2%). The food price reductions that had been anticipated by the

Consumer Strategy Group had not materialised. One of the reasons was that the economy continued to grow, and it would appear, that all elements of the grocery supply chain prospered. Customers continued to willingly pay the prices retailers demanded and there was little reason to change behaviours. No retailer had an incentive to defect from the institutionalised pricing regime established over the previous nineteen years

"Up to recently everybody was making their margin and as long as you're making your margin there is no incentive to change" (Buyer 2).

So what exogenous shock led to change? According to the buyers interviewed, eventually a combination of economic and market factors led to a significant shift in the dynamics of competition with increased price competition, along with a revaluation of the sourcing models used. First, there was the gradual but continual growth of the discounters which would have had the effect of reducing the quasi rent pool earned by suppliers and retailers alike. However it is likely that this effect would have been symmetric and affected all retailers similarly. However during 2008, the rapid rise in the value of the Euro relative to Sterling (figure 4) encouraged a growing stream of customers to shop in Northern Ireland where significant savings could be made. This would have had a profound effect on the existing quasi-rent based model. In the first instance, the primary beneficiaries of the increase in cross border trade were Asda and Sainsbury who despite having no outlets in the market were estimated to have almost 2.5% of the Republic of Ireland grocery market (Cullen 2009). Shoppers were switching stores in increasing numbers and the effect would have been to reduce the quasi rent pool available for distribution in the Republic. From an international branded supplier's perspective, the effect was bearable as the location of their sales had merely been displaced. However on the retail side Tesco, due to the location of its stores, suffered most from the increase in cross border sales (Retail Intelligence April 16 2009). With both a shrinking quasi-rent pool and declining sales, a retailer had an incentive to defect. Tesco responded by reducing prices in its border stores before rolling out the price cuts throughout the Republic over the following months. Supervalu with its '*Sterling Price Match*' programme throughout 2009 also sought to reduce the flight of customers across the border,

Figure 4. The Rise of the Euro



Tesco's "*Change for Good*" initiative also involved a redesign and realignment of its existing sourcing practices and a substantial review of its product portfolio. Central to the initiative was a greater role for its UK buying office, the introduction of "*Change for Good*" plannogrammes, and a decision to source international products directly from the UK rather than offices located in the Republic of Ireland. Dunnes Stores, the second largest of the multiple retailers, responded to Tesco's price cuts with a reported 30% cut in the price of a basket of goods throughout its store portfolio. In the period January to June 2009, the National Consumer Agency reported a fall in the price of a basket of branded goods of between 14%-15% in Dunnes Stores and the Tesco Stores operating the Change for Good pricing initiative. Changing market forces had eventually reignited price competition.

Conclusion

The evidence provided by the Irish experience of below cost legislation is similar to that seen in France (Colla 2006). It highlights the intractable difficulties of calculating the

"real cost" of an item to a retailer. As below cost legislation is by definition based on the assumption that cost can be identified, this presents a major conceptual hurdle for this type of legislation. In Ireland it was recognised that the net invoice price was a poor proxy for the "real cost" but had the advantage that it could serve as a basis for legislation. As had always been feared, the use of net invoice price had the undesirable effect of encouraging off-invoice discounts and reintroducing a form of resale price maintenance.

The findings also suggest that the legislation created two streams of quasi-rents. The first, higher than necessary returns to suppliers' brands, could be appropriated by retailers seeking discriminatory discounts. The second were higher than necessary returns to retailers' own brand products. These flows of returns provided retailers with little incentive to change their behaviour until the size of the rent pools began to diminish with the growing flow of consumers across the border.

It can also be argued that the legislation when coupled with Government intervention during Tesco's entry into the market, impeded supply chain developments and the competition it might have created. More international sourcing, particularly for international brands and own brand products, would have challenged the quasi resale price maintenance model that existed in Ireland. In such circumstances, the Irish model would have failed to compete and would have had to evolve. The legislation did not prevent retailers and wholesalers re-configuring their sourcing models. The problem was that neither retailers nor their suppliers had an incentive to change. Streams of quasi rents were being generated in the market and a sufficient proportion of these were being appropriated by retailers to maintain the status quo. Times were good and budgeted margins and sales were being met. Existing business models and behaviours had become institutionalized. It took a dramatic change in the fortunes of the economy to change the nature of competition. This points to the importance of the contextual setting and how this may evolve over time.

The fact that prices were slow to fall after the abolition of the Groceries Order confirms the view that retailers would rather avoid price competition when possible. The industry

had been conditioned. The negotiating processes and supporting structures had been established for almost nineteen years. The industry, and its consumers were not price driven. The legislation provided the means for supporting higher prices, through quasi-guaranteed adjusted gross margins with off invoice rents, and perhaps even established a business culture that suppressed price competitive forces. It was within the means of the various retailers to reduce prices while adhering to the legislation for many of the years during which the regulation applied. If retailers needed to compete on price, the threat of new sourcing models with increased purchases from the UK would have facilitated a reduction in net invoice prices.

So to conclude, did the legislation really matter? The evidence suggests that it did and in a way that policy advisors feared. Primarily, it served to dampen price competitive forces and maintain prices at a level higher than they might otherwise have been. The evidence also suggests that by establishing quasi-rent flows, the legislation resulted in unnecessary complexities and inefficiencies to both suppliers and retailers' businesses. Finally, would the legislation matter today? The downturn in the Irish economy and the emergence of a very price driven shopper forced Irish retailers to reduce prices to maintain market share. To respond to this different environment, any artificial constraints to reducing prices such as off invoice discounts would likely be removed and the shift to international sourcing and the exploitation of economies of scale would have accelerated.

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