Uk supermarket industry oligopoly economics essay

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The industry I will be analysing is the UK supermarket industry. There are four main competitors within the UK supermarket industry, Tesco, Asda, Sainsburys and Morrisons. These four companies dominate the market, which is proven by their market shares that are substantially higher than any other company operating within the market, because of this the UK supermarket industry forms an oligopolistic structure. The domination is so severe that together the four main competitors held 66. 6% of the market share in 2011, which is broken down into Tesco having 26. 9%, Asda 15. 2%, Sainsbury’s 14% and Morrisons 10. 5%. This is shown within Figure 1, along with the other companies operating within the market that form the top ten market shares. The graph clearly shows how the UK supermarket industry is viewed to have an oligopolistic structure as there are only four companies that have a significantly larger market share than the rest.

Figure 1

Mintel – November 2012

The nature of an oligopolistic market means that companies are always competing with each other to attract consumers to buy from them. In an ideal world companies would prefer non-price competition in order to avoid price wars. A price reduction may achieve strategic benefits, such as gaining market share after a boom in sales but the danger is that these benefits will not last and soon enough rivals will simply reduce their prices in response. This leads to little or no gain and may lead to falling revenues and profits (Economics Online). Within the UK supermarket industry there is presently a price war occurring, known as the price match guarantee. After Asda promised vouchers to customers if their shopping is less than 10% cheaper

than Tesco, Tesco themselves retaliated after a drop in market share by drastically dropping prices then participating in a price match voucher system of their own, this led Sainsbury's to also begin presenting customers with vouchers if their shopping was more expensive than either Asda or Tesco (Reuben 2011).

http://upload. wikimedia. org/wikibooks/en/e/e1/KinkedDemandCurve. gif

Figure 2

Wiki Books 2012

The theory of price wars can be explained by the kinked demand curve model, which was developed by Paul Sweezy in 1939. It assumes that firms are suspicious about how their competitors will react to them increasing or decreasing their prices. Oligopolistic companies believe that if they cut their prices, their rivals will follow because they will be worried about losing sales. Therefore, they assume that demand will be price inelastic if they cut prices, meaning the small increase in demand will be less than the increase in price in percentage terms. However, oligopolistic companies also believe that if they push up price, their rivals will be happy for them to be the only ones doing so and will not follow. This means that demand will be price elastic if they put the price up, meaning the decrease in demand will be larger than the rise in price in percentage terms. These assumptions mean that the demand curve is kinked around existing prices and that there is no incentive to change price. A price cut leads to a small increase in quantity demanded, so revenue would fall, this is shown in Figure 2, where the demand line increases slightly. A price increase leads to a large decrease in quantity

demanded, so again revenue would fall, this is shown in Figure 2, where the demand line decreases rapidly. It is therefore better to keep price as it is (Gillespie 2010).

Another pricing strategy that occurs within oligopolies is the cartel price collusion. It is where the dominant firms within an oligopolistic market work together to try and maximise the profits available to them by restricting output and pushing up price (Gillespie 2010.) Firms know that they don’t have to worry about consumers going to their competitors for cheaper prices as all companies are as attractive as each other in terms of price. However this strategy is illegal and exactly what governments try to prevent, they fear that the consumers will lose out and have to pay more than for products than what they are used to paying. Between 2002 and 2003 Tesco, Asda, Sainsbury’s and Morrisons colluded with dairy producers to increase the prices of milk by 2p a litre and cheese by 10p per 500g. The Office of Fair Trading fined the supermarkets £49. 51 million after anti-competitive behaviour aimed at increasing prices for consumers occurred (Poulter 2011).

http://www. tutor2u. net/economics/revision-notes/a2-micro-oligopoly-overview_clip_image003. gif

Figure 3

Riley 2006

Under a cartel arrangement, the dominant firms may decide how much output each one will make and at what price this will be sold. In effect, the individual businesses are joining together to act like a single monopolist. Customers will end up paying more than they would in a competitive market

and the companies involved will benefit from maximised profits. Figure 3, above, shows how a cartel works, the cartel is fixed at where QM (Output) and PM (Price) meet, under these circumstances it makes profit equal to the shaded area on the left hand side (Gillespie 2010). Within a cartel, there is an incentive to cheat. A firm could increase output to take advantage of the higher price and consequently make a higher profit at the expense of its rivals. However if a firm did do this then, they would be unable to take part in cartel arrangement again as they would have lost the trust of the other firms within the market. This links in with the ‘ prisoner’s dilemma’, a part of game theory that has been used to describe oligopolistic firms’ relationships. It shows the dangers of an oligopoly from a dominant business’ point of view; where a lack of trust may lead to an outcome where firms are worse off than if they trusted each other (Gillespie 2010).

A 2012 report by Mintel stated that recently, without establishing a cartel, the four major UK supermarkets seem to have reached a stable pricing structure which nobody wants to disturb. This suggests that there is no real competition on price anymore and focus has turned to all other basics of retailing, location, quality, range, store layout and service (Mintel November 2012). These non-price strategies are of great importance within oligopolistic markets due to companies’ interdependence in relation to pricing strategies. Companies can’t be sure of competitors’ reactions to price changes; there is a chance that a rival firm in the market will also change their prices in retaliation. A non-price strategy that has been extremely successful for Tesco and Sainsbury’s is the introduction of the loyalty scheme. In 1995 Tesco launched the Clubcard – a loyalty scheme that rewarded shoppers with

vouchers that offered discounts if they shopped regularly at Tesco. Within one year, consumer spending at Tesco had increased by 28% while at Sainsbury's it decreased by 16%. In retaliation Sainsbury's responded with its own reward card called the Nectar Card (Trench 2010).

Oligopolies frequently maintain their position of dominance in a market because it is too costly or difficult for potential rivals to enter the market. These hurdles are called barriers to entry and the dominant firms can either erect them deliberately to create artificial barriers, or they can exploit natural barriers that already exist (Economics Online). Product differentiation is another non-price strategy that also acts as a barrier to entry. A new company looking to enter the UK supermarket industry would need to achieve a unique level of product differentiation and gain an identity through promotions and costly advertising. However due to the oligopolistic structure of the market, the dominant firms operating within it have super normal profits, enabling them to make significant investments in advertising and promotion. A new entrant would find it almost impossible to gain a foothold in the market as they would not be able to compete with the mammoth spending of the dominant companies within the UK supermarket industry just as Figure 4 shows. Tesco spent £146 million on advertising in 2011, making it the UK's biggest grocery advertiser, the figure was only 0. 22% of their turnover for that year (Mintel November 2012). The costs for a new entrant to compete with the likes of Tesco will deter entrants from entering the market.

Figure 4

Mintel November 2012

Figure 4 Mintel 2012

An artificial entry barrier and pricing strategy used to try and preserve firms' dominance within an oligopolistic market is known as predatory pricing. It is where dominant firms set their prices very low to try and prevent a new competitor from entering the market. When there is a threat of a new firm entering the market, existing competitors lower prices to a price that a new entrant will not be able to match, resulting in them deciding to not enter the market. Even if the price set is so low that the ' predator' is making a loss, predatory pricing is still illegal under competition laws. It is considered to be anti-competitive and therefore not in the best interests of customers within the market as they are denied a wider choice. Although, to prove a firm is participating in predatory pricing is difficult to prove. When a significant price discount is applied to products it almost impossible for the government to prove that a firm is applying the discount on the basis of predatory pricing and not part of a sales promotion (Riley 2011). In 2005, 32, 000 small shopkeepers launched a legal appeal to try and stop large supermarkets wiping them out. The Association of Convenience stores are accusing the dominant supermarkets of predatory pricing tactics which are destroying the market and their revenue. An example of predatory pricing was given, stating Tesco were able to sell Easter eggs cheaper than a small shopkeeper was able to buy them for (Barrow 2005).

The oligopolistic structure of the UK supermarket industry is a major reason why Tesco's recent performance has faltered and for the first time since

1990 it seems to have encountered problems. Tesco has focused too much on maintaining its giant market share, and not enough focus has been given to the basics of retailing. Experts say that Tesco have put too much effort into competing with other supermarkets on the price match guarantee by cutting prices that as a result, ‘ day to day’ costs have been cut too far and consequently service levels have fallen, the stores are looking tired and in need of investment. Mintel’s consumer research states that Tesco have the lowest proportion of customers who drive past other stores to get to it, suggesting that customers have responded to the drop in standards and aren’t afraid to shop elsewhere (Mintel March 2012).

To conclude, oligopolistic markets such as the UK supermarket industry are frequently criticised on the basis of the strategies they undertake. Pricing strategies such as price collusion and predatory pricing are viewed in a negative light as it affects the consumer and the market in a negative way, however oligopolistic markets also have their advantages that they bring to the economy. The extremely large profits they generate may be used to participate in innovation, in which case the consumer will eventually benefit from. Also the price stability of oligopolies may bring advantages to consumers because it helps them plan their expenditure. Overall, oligopolies are and always will be significant because they dominate many sectors of the UK economy.