WESTPAC ECONOMIC BULLETIN

Grocery Retailing in New Zealand.

12 May 2023

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Positive steps, but not transformative.

Recommended changes to how New Zealand's supermarket duopoly operates are now progressing at pace. While the proposed reforms are touted as being transformative, we don't think they will generate sufficient competition to deliver significant benefits for the consumer. Real change in the grocery sector will require a significant structural shift. While in the short-term reducing the level of industry concentration might result in the loss of economies of scale and increased costs to the consumer, in the longer-term there is potential for stronger competition to increase innovation, deliver better prices and improve the shopping experience.

- The current cost of living crisis and growing concerns over food prices have brought last year's Commerce Commission's grocery sector recommendations back into focus.
- Government, in conjunction with industry is well progressed on implementing these recommendations.
- Nevertheless, we think that stronger measures will be required to generate enough competition to deliver the outcomes that Government seeks.
- Our view is that this can only be achieved by introducing more competition throughout the grocery value chain and hence breaking up the existing duopoly. We think that reforms should begin by reducing linkages between large grocery chains and suppliers/manufacturers (vertical de-integration) and then reducing horizontal integration by encouraging new players into grocery retailing.
- This would involve some tough policy trade-offs, including potentially higher prices in the short term as economies of scale were lost. Longer-term, however, we would expect the benefits of a more level competitive playing field to be reflected in better prices, a wider range of goods and an improved customer experience.
- Any reforms that improve industry competitiveness will be helpful in improving the responsiveness of grocery prices to changes in consumer demand, aid the transmission of the Reserve Bank's monetary policy to the benefit of the entire economy and deliver a better more modern customer experience.

Context.

In late 2020, the Commerce Commission undertook a study on whether competition in New Zealand's grocery sector was adequate and if necessary to identify ways to improve it.[1] The current duopoly, raises potential competition concerns and associated high grocery prices.[2] The fact that the New Zealand grocery retailing sector is highly profitable despite being relatively less cyclical and hence less risky will also have been a factor motivating the review.[3]

In early 2022, the Commission released the findings of its study, which identified that competition in grocery retailing wasn't working well for the vast majority of New Zealanders.[4] To address that, the Commission made several recommendations, which it hoped would boost competition, and result in meaningful improvements in the price, quality and range of groceries and services available to the average Kiwi.

Relative grocery prices.

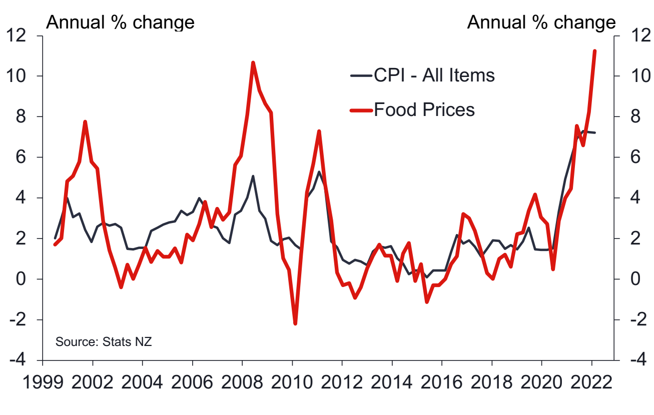
The Commission noted that it is difficult to compare price levels between countries, but nevertheless concluded that grocery prices in New Zealand are high by International Standards.

OECD and ICP data indicated that groceries prices in New Zealand were the 5th highest in the OECD.

Further, NUMBEO's Grocery Index which compares grocery prices by country, placed New Zealand 17th out of 140 countries in 2023.

That's important because almost a fifth of what Kiwi's spend each week goes on groceries, making rising food prices a key element of the currently perceived cost-of-living crisis. Consumer NZ's Sentiment Tracker shows that food costs now rank second on the list of household financial concerns. As food is a regularly purchased good, it's likely to be a key factor shaping consumer inflation expectations, which is an important consideration for the Reserve Bank as it charts the future path for the Official Cash Rate.[5]

Figure 1: Food price vs headline inflation



Government response.

The Government accepted all but two of the Commission's recommendations and is now focused on implementation. Those that weren't accepted were subsequently amended to give them more bite.

Two key pieces of legislation are relevant here.

The first is the Grocery Competition Bill, which is expected to come into law soon. A key element of this bill is a requirement that New Zealand's two dominant grocery retailers, Foodstuffs and Woolworths NZ, provide competitive wholesale access to independent retailers. Up to now many of these smaller retailers have been forced to purchase at retail prices, putting them at a competitive disadvantage. Should Foodstuffs and Woolworths NZ not comply, the Bill allows for a sector regulator to intervene directly into the market mechanism, allowing it to impose "must supply" obligations, as well as other terms and conditions of supply, including the setting of prices.

The Bill though doesn't stop there. Manufacturers and growers have longed complained about what they consider to be unfair practices adopted by the two dominant retailers. Included here are the various fees and rebates that supermarket typically charge their suppliers. To rectify that, the Bill provides greater scope for suppliers to collectively negotiate with retailers (subject to the development of an exception to the Commerce Act 1986), allows for a mandatory code of conduct, as well as the establishment of the aforementioned regulator and dispute resolution mechanisms. Further measures to strengthen unfair contract terms are included in the Fair Trading Act.

Retail profitability.

Grocery retail is a profitable business.

According to data from the Annual Enterprise Survey (AES), grocery stores generated sales of $26bn in 2021 and a 21% margin on sales of goods for resale.

The sector generated an EBITDA margin of about 4% which is higher than the 3% estimated by the Commission for a comparable sample of international grocery supermarkets.

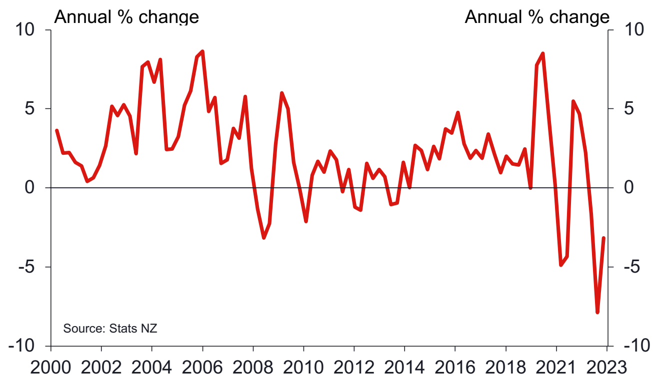
According to the AES, grocery retailers and supermarket generated a return on equity (ROE) of 30% in 2021, which is significant given that their fortunes are less closely tied to the economic cycle than many other service industries.

The Commission estimates that return on average capital employed (ROACE) by our big supermarkets is just over 12%, which is also higher than what comparable international grocery retailers achieve. The Commission also notes that this ROACE is more than double that estimated as being normal for grocery retailing in New Zealand.[6]

[1] See https://comcom.govt.nz/about-us/our-role/competition-studies/market-study-into-retail-grocery-sector
[2] High grocery prices were cited by the Commerce and Consumer Affairs Minister as key reasons for the study
[3] There are many industries in New Zealand, such as financial services, that are dominated by a handful of firms. Few, however, are as vertically integrated as the grocery retail sector where the incumbents have a dominant position through the value chain.
[4] See https://comcom.govt.nz/about-us/our-role/competition-studies/market-study-into-retail-grocery-sector?target=documents&root=228475
[5] A recent research paper from the BIS shows empirically that households are more influenced by the prices of frequently purchased items when shaping perceptions of inflation and inflation expectations – https://www.bis.org/publ/bisbull55.pdf
[6] See pages 44 and 45 at https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf

Another measure already implemented was the Commerce (Grocery Sector Covenants) Amendment Act, which now prohibits restrictive covenants on land and exclusivity lease covenants that limit new grocery store development. New Zealand's big grocery retailers had reportedly held well over 100 such arrangements, which were seen to be limiting the ability of new entrants to establish themselves in prime sites.

Figure 2: Supermarket and grocery stores real sales growth



The Government has also asked the major retailers to address ongoing issues relating to pricing and the various loyalty programmes they operate. Pricing errors and misleading and complicated promotions are a common complaint from customers as recent media reports on supermarket specials would seem to attest. Measures to be taken include simplifying pricing and promotional practices, making sure unit prices are displayed in a consistent manner and ensuring proper disclosure on loyalty programmes.

Government is building the legal and regulatory framework to action the Commission's recommendations.

Sector response.

The two big grocery retailers welcomed the recommendations and have made some changes. In addition to some price reductions, they have participated in the development of a mandatory code of conduct for the sector, have started to open up their wholesale channels to independent retailers and have progressed the removal of land covenants.[7]

The observed enthusiasm of the large grocers to take action somewhat reflects the fact that our biggest retailers have got off relatively lightly. While the Government's measures added some extra bite, the Commission's final recommendations were watered-down compared to earlier more far-reaching proposals that recommended the breakup of the existing duopoly and the possible setting up of a new state-owned supermarket chain. Such changes would have been very disruptive to the industry and saw pushback that prompted government to move forward with less far-reaching reforms – at least for now.

Big grocery retailers have embraced the Commission's relatively modest recommendations.

Implications.

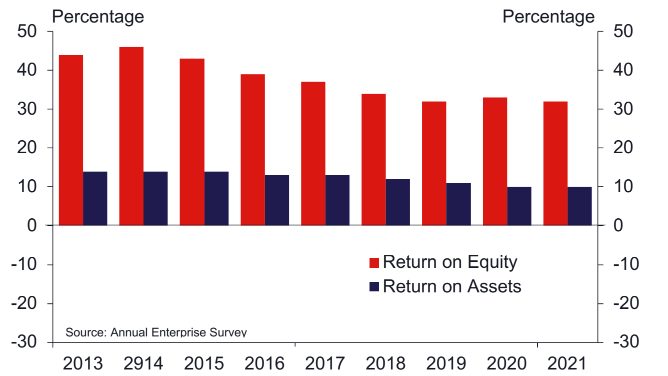
The question then is whether these recommendations will deliver the outcomes that the Government has said that it is looking for in terms of greater competition, more innovation, lower prices, and a better quality and range of groceries?

On the face of it, they should. Reducing barriers to entry by removing covenants and providing access to wholesale goods on commercial terms, increasing supplier power by introducing a mandatory code of conduct and collective bargaining, and boosting the power of consumers by making loyalty programmes and promotions easier to understand, should all lead to more competition, better prices, etc.

In reality, however, we doubt this will occur. At least that is what the overseas experience suggests. Many of these recommendations, for example, including those that relate to the establishment of a code of conduct, have already been implemented in the UK, with limited success.[8] Similarly, in New Zealand, the regulation of Telecom failed to deliver better prices to its customers.[9]

The real issue is the extent that the changes introduced by the Government address the power imbalances that exists along the value chain. Foodstuffs and Woolworths NZ control north of 80% of the market, making the New Zealand's grocery retail sector one of the most concentrated in the world.

Figure 3: Supermarket and grocery stores returns



By comparison, the two top grocers in Australia, Canada, the US and UK control about half of their respective markets.[10] To deliver the outcomes that it seeks, Government would have to make a big dent in that number.

[7] By the middle of 2022, Foodstuffs had removed covenants on 78 of 135 affected titles or properties where it had previously prohibited competitors from building new stores
[8] See https://theconversation.com/as-the-commerce-commission-found-theres-no-magic-way-to-make-nz-supermarkets-more-competitive-178762
[9] See https://www.nzherald.co.nz/business/retail-nz-sceptical-government-intervention-in-grocery-sector-will-serve-up-cheaper-prices/TSSGWI7CD5T6R4OZX5QLE4HJJE/
[10] See https://thespinoff.co.nz/money/18-11-2020/price-check-government-investigates-high-food-prices-at-supermarkets

That is not going to happen anytime soon. Providing customers with clear pricing information might seem like a good idea and well intentioned, but it doesn't materially affect the power of buyers. That's because their purchasing options are essentially limited to the two big grocery retailers, both of whom are well aware of each other's pricing strategies (and can respond accordingly). Not only that, but an Ipsos Survey in 2021, suggested that while price was an important driver of choice for customers, comparing prices was considered difficult and time consuming.

Similarly, increasing the power of suppliers does not necessarily mean better prices for customers. Indeed, the opposite is more likely. Suppliers have complained for many years of the pressure exerted by retailers, who have been able to leverage off their bulk buying power. Strengthening the hand of manufacturers/growers by allowing collective bargaining and/or by establishing a code of conduct, is likely to push up supplier prices, which are then likely to be passed on by the duopoly to its customers.

That said, the impact of reducing barriers to entry is less clear cut. On the face of it, removing covenants on land is a good idea but that doesn't mean that players outside of the duopoly will necessarily set up shop as other factors are at least as relevant, such as the catchment area, customer demographics, and changing customer preferences. Also important is the impact of digitalisation, which is quickly transforming not only how goods are supplied, but also how retailers and customers interact with each other. The existence of established, well-resourced incumbents nearby, can also make it difficult for new entrants to establish a foothold.

Indeed, we have already seen online supermarket, Supie, coming under a bit of pressure from its suppliers to raise retail prices. This perhaps reflects the weak negotiating position of suppliers and concerns that discounting from a new entrant might prompt the incumbents to also lower prices and reduce prices paid to suppliers to compensate.

That said, we do think that forcing the duopoly to negotiate wholesale offerings to competitors on commercial terms could help to increase competition and bring down prices. What matters here though is the big stick wielded by government, and its apparent willingness to impose controls should price levels not reflect what they would expect in a competitive wholesale market. That raises some practical issues, not least of which relates to the monitoring of prices across literally thousands of product lines. Who does what, when and how quickly?

Introducing price controls is also likely to lead to distortions up and down the value chain. A key question is how would controlled price levels be determined and how responsive would they be to real-time dynamics in upstream supplier markets? If they are unresponsive, it's quite possible that suppliers could find themselves being squeezed should their market determined input costs begin to rise. It is also possible, of course, that wholesalers facing price controls might look to reassess their product lines and focus only on those that are the most profitable. That would have the effect of reducing the range of products available, which is the exact opposite of what the Government is looking to achieve.

The Commission's final recommendations are unlikely to be a game-changer.

The alternatives.

So, we are not very optimistic that the Government will be able to rein in the big grocery retailers. While there may be some changes at the margin, we think that the two big vertically integrated grocery retailers will continue to dominate with limited upside for the consumer.

What's really needed is the restructuring of the sector, and that includes measures that would dilute the power of the current duopoly.

But you do have to be careful what you wish for. Forcing the big grocery retailers to vertically unbundle their wholesale operations might be tempting, but it's not clear whether that by itself would result in greater competition given the dominance of the big downstream retailers and their ability to bulk buy to maintain market position. Indeed, if anything, breaking up the supply chain is likely to reduce efficiency levels in the short term, meaning higher costs would be passed onto downstream consumers in the form of raised prices.

One possible way around this would be to also force the big grocery retailers to separate horizontally. But shedding retail stores is not necessarily a panacea for consumers. While vertical and horizontal disintegration may result in stronger competition and generate longer term benefits, in the short-term the costs associated with disinvestment and the potential for inefficiencies because of an even more fragmented supply chain and a loss of economies of scale would likely flow to consumers.

Alternatively, the Government could have gone for the much-touted option of actively encouraging a large third grocery retailer to take on the existing duopoly. However, a new entrant might not generate significant benefits for consumers for a while given the need to recoup the investment required to establish a functioning supply network. It may be difficult to encourage a new entrant given no new major international players have entered the market despite the apparently high returns on offer.

Restructuring the sector will be disruptive and could impose near-term costs on consumers before long term benefits are realised.

Our view.

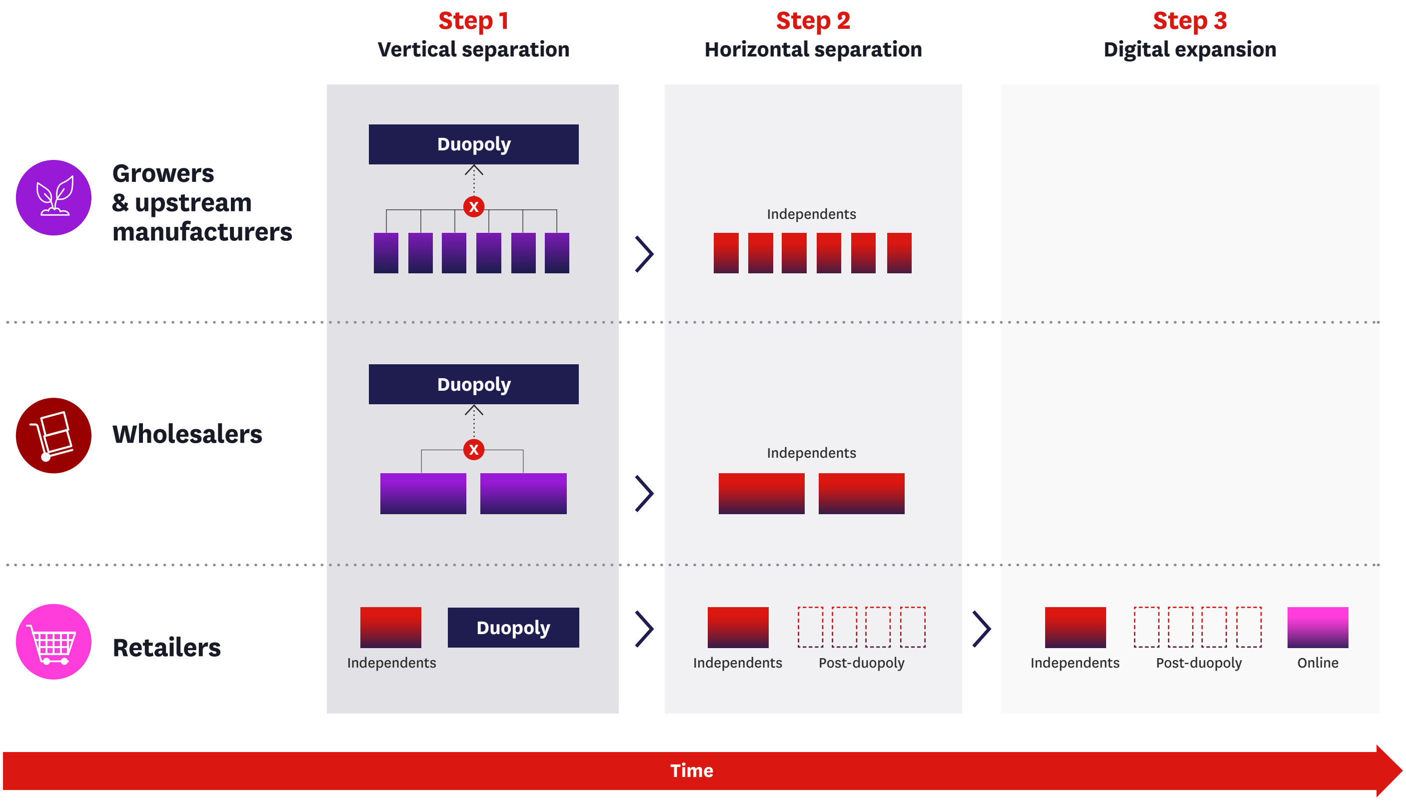
Our view is that the reforms do not go far enough to effectively stimulate competition. We acknowledge that breaking up the existing retail hegemony is complex, fraught with unintended consequences and may impose short term costs on customers.

The industry, sanctioned by regulators, has actively pursued economies of scale through mergers and acquisitions (and hence horizontal and vertical integration) since the early 1980s. The impact has been to give the duopoly the kind of control that makes it much easier to set prices at the checkout till.

This consolidation process needs to be reversed if Government is looking to improve the lot of the average Kiwi over the longer term.

To that end, we think that the Government should set out a strategy road map that identifies the key milestones that need to be achieved to level the competitive playing field. That road map would need to be backed up by appropriate legislation – the sector will not unbundle voluntarily.

Figure 4: Warehouse automation process technologies



Step 1

Would require the vertical separation of the supply chain. That should start with creating clear separation between manufacturers and wholesalers and then between wholesalers and retailers. That means that the duopoly will have to choose where it wants to operate and sell off those parts that it doesn't.[9]

Step 2

Requires horizontal separation at the retail level. That means that Foodstuffs and Woolworths NZ be forced to sell off some of their individual retail brands to independent retailers, possibly extending as far as the selling off specific outlets. Again, that assumes the existence of buyers, who may be put off by the big structural changes occurring within the sector. While that is a big assumption, new entrants may be enticed by attractive returns that are on offer.

Step 3

Requires that Government create the conditions to encourage online grocery shopping. As mentioned, digitalisation is fundamentally changing how goods destined for retail are supplied and how retailers and consumers interact with each other. The idea of supplier ecosystems that dropship directly to customers on behalf of online retail is already here, and there is no reason why, with some modifications, that cannot be extended to grocery shopping. Indeed, online supermarket, Supie is already here and clearly making waves. Other new entrants are needed.

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