Assessing retail grocery competition

Comments on submissions to the Commerce Commission on the Preliminary Issues Paper

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Definitions

CAPM	Capital Asset Pricing Model
Commission	Commerce Commission
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest and Tax and Depreciation
FSNI	Food Stuffs North Island
FSSI	Food Stuffs South Island
NZ	New Zealand
NZFGC	New Zealand Food & Grocery Council Inc
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing Power Parity
ROCE	Return on Capital Employed
SSNIP	Small but significant and non-transitory increase in price
WWNZ	Woolworths New Zealand Limited

Executive summary

This report outlines best practice principles for assessing competition in the retail grocery market. These principles draw on issues we identified in our review of the submissions on the Commerce Commission's *Market Study into the retail grocery sector preliminary issues paper*.

Close substitutes are most relevant when assessing competition

What is relevant to the Commission's market study is not simply whether alternative food retailers exist, but whether the behaviour of supermarkets is materially constrained by the availability of those alternatives.

The best technique to determine whether a substitute is sufficiently close to constrain supermarkets behaviour is the hypothetical monopolist (or "SSNIP") test. We apply the test at a conceptual level that and find that:

- Value-added food and beverage retailers such as takeaway retailers, cafes and restaurants are not close substitutes for supermarket grocery supply. These retailers typically provide a different service with prices that reflect additional inputs to supply prepared ready-to-eat meals
- Convenience stores typically sell goods at a significant premium to supermarkets, and stock a limited range of products. As a result, these stores are unlikely to place a significant competitive constraint on supermarkets
- Premium food subscription services (meal kits) are also unlikely to be in the same market as supermarkets because consumers are unlikely to shift their consumption towards food subscription services at a scale that makes a SSNIP unprofitable for supermarkets
- Purchase of individual grocery types from specialist suppliers is generally unlikely to be a sufficiently close substitute for full-service supermarkets, potentially with some exceptions. Consumers value the convenience of a bundled shop and are therefore unlikely to unbundle their supply of groceries in response to a SSNIP by a hypothetical supermarket monopolist. Information that may help the Commission assess the extent of competitive pressure that speciality supply places on supermarkets includes: information on the value that consumers place on convenience, the cost that consumers would face in purchasing from specialised suppliers and the range of products that customers typically purchase when shopping at a supermarkets.

Full-service grocery supply is likely the key market relevant to assessing the extent of competition in the retail supply of groceries.

Economic profits, rather than accounting profits, are relevant to competition assessment

Woolworths New Zealand Limited (WWNZ) states in its submission that it is a low margin business and that this reflects a highly competitive retail grocery sector. WWNZ supports this conclusion with information on accounting profits. However, economic profits, rather than accounting profits, are relevant to competition assessment. In other words, what is relevant is whether a firm's return on capital is higher than a reasonable expectation of a required return, given the risk associated with investing in the business.

We anticipate that the Commission will consider relevant profitability measures in detail as it did in the fuel market study, and then examine grocery retailers' profits using the measures it finds to be appropriate. As a result, we do not examine profitability measures in detail in this report.

The lack of publicly available information on supermarkets that are members of the Foodstuff cooperative, and the absence of balance sheet information for WWNZ means that we cannot examine the return on capital for any of the NZ supermarkets participants. We note that Woolworths Australia's return on capital employed (ROCE) sat at 25 percent from 2017 to 2019. The reported ROCE fell in 2020 13.7 percent, but this change appears to be fully explained by a difference in the treatment of leases.

Woolworths Australia's returns seem to greatly exceed what would be expected for a defensive company with a low asset beta from a Capital Asset Pricing Model (CAPM) perspective, and do not indicate a strongly competitive market. NZ likely has less competition for retail grocery supply than Australia, because Aldi and CostCo are both currently active in Australia. As a result, returns on capital for NZ grocery retailers also seem likely to be excessive.

To investigate whether economic profits are being earned by grocery retailers in NZ, we recommend that the Commission collects financial information from WWNZ, at least a sample of Foodstuffs' member supermarkets (across banners, locations and size), and the Foodstuff cooperatives.

International price comparisons must be carefully constructed and interpreted

Price comparisons should be constructed with the relevant purpose in mind. Having a clear view of the question that we are seeking to answer makes methodological choices more robust.

NERA correctly identify a number of challenges in conducting international benchmarking, including:

- The need to compare across different countries prices are surveyed in different currencies
- Consumers in different countries have different buying habits and preferences
- Product quality and specification may vary across countries
- Taxes can affect prices differently across countries.

We agree that these issues are highly relevant to any price benchmarking assessment and should be given careful consideration. However, rather than attempting to identify the best methodology to use in light of these challenges, and in the context of examining the extent of competition, NERA uses a simple off-the shelf dataset called the CityData tool.

We are unable to fully comment on the methodology used to create the dataset due to the lack of clarity and information provided on how the dataset is collected. It is unclear if NERA is fully aware of the methodology used.

However, based on the information that is available, we find a number of problems with the dataset, including the lack of clarity on what types of stores are included internationally, whether the geographic choice of comparators is relevant, the lack of adjustment for taxes and excise duties, and the lack of assessment of cost differences across countries.

Based on our review, we conclude the results of the NERA price comparison analysis should not be relied upon to make any conclusions on how the extent of grocery competition in NZ compares internationally**.** At best, the NERA analysis raises some of the methodological issues that the Commission would need to consider if it undertakes a price comparison.

The likely effect of private labels must be assessed in the specific context of the NZ's grocery market structure and the organisational context of the NZ retailers

As WWNZ, Food Stuffs North Island (FSNI) and Food Stuffs South Island (FSSI) point out, private labels can bring benefits to consumers through increased choice for consumers, and can also increase competitive pressure on suppliers which could lead to lower prices for consumers. However, as highlighted by Consumer NZ and the Food & Grocery Council (FGC), the growth of private labels could have the potentially lead to a loss of consumer choice and higher prices over the longer term.

Importantly, the Commission needs to carry out its analysis of the likely effects of private labels in the specific context of the relevant markets in NZ, given:

- The structure, concentration, and degree of market power in the relevant retail grocery market
- The extent of buyer power that the supermarkets already hold for each of the relevant upstream markets for the supply of grocery goods
- The incentives on grocery retailers in NZ, given their ownership and operating structures.

The arrangements for supply of private label products by supermarkets in NZ may affect incentives to promote those products relative to competing products. These arrangements include:

- The agreements between WWNZ and its parent company, under which WWNZ supplies private label products, including management incentives, and
- The agreements between FSNI, FSSI, and their respective cooperative members for supply of private label products, including incentives.

These agreements may, for example, contain incentives to sell certain volumes of the private label products, or requirements to promote private labels products in certain ways. These contracts or arrangements are important to understanding whether supermarkets in NZ are likely to have incentives to favour private label supply, over the supply of competing products. For example, supermarkets may have incentives to favour private labels by providing preferential access to premium shelf space, applying a lower margin to private labels than to other products, providing advertising or promotion opportunities that are not available to other products, or applying charges to competing suppliers but not requiring the private label to contribute towards those costs.

We recommend that the Commission gather information on the arrangements between Foodstuffs supermarkets and the cooperative, and between WWNZ and its parent company, regarding private label supply to better understand the supermarkets' incentives and the implications for market outcomes.

1 Introduction

The New Zealand Food & Grocery Council Inc (NZFGC) engaged Castalia to provide feedback to the Commerce Commission (Commission) on submissions to the Commission's *Market Study into the retail grocery sector preliminary issues paper*.

Drawing on the issues we identified in our review of the submissions, we discuss a range of best practice principles for assessing competition in the retail grocery market to assist the Commission as it progresses its market study.

This report is structured around the following observations on the submissions:

- Close substitutes are most relevant when assessing competition (section 2)
- Economic profits, rather than accounting profits, are relevant to competition assessment (section 3)
- International price comparisons must be carefully constructed and interpreted (section 4), and
- The likely effect of private labels must be assessed in the specific context of the NZ's grocery market structure and the organisational context of the NZ retailers (section 5).

2 Close substitutes are most relevant when assessing competition

To properly analyse the nature of competition for grocery retailing, the Commission will need to examine which alternative retail sources place a significant competitive constraint on the behaviour of supermarkets. While the supermarkets claim a broad market exists, full-service grocery supply is likely the key market relevant to assessing the extent of competition in the retail supply of groceries.

FSNI, FSSI, and WWNZ claim they compete in a broad market of traditional and non-traditional service offerings. WWNZ refer to a "food market" which includes restaurants, convenience stores, meal kits, and a range of specialist retailers. WWNZ argues that the range of offerings demonstrates an "intensely competitive and dynamic" grocery sector.[1]

What is relevant to the Commission's market study is not simply whether there are alternative food retailers, but whether the behaviour of supermarkets is materially constrained by the availability of those alternatives.

Given that the current report is prepared in the context of the Commission's Preliminary Issues Paper, the purpose of our analysis is not to conclusively define relevant markets. Instead, we seek to firstly identify which services are least likely to be relevant to the Commission's study and can be set aside, and secondly, for remaining options, we identify what information or analysis may be useful to confirm whether those options are likely to be close substitutes for supermarket supply.

[1] Quoted at page 11, WWNZ Submission.

We consider how relevant these retail options are to the assessment of grocery competition with reference to the "small but significant and non-transitory increase in price (SSNIP) test (also referred to as the hypothetical monopolist test). This test is commonly used in competition law to identify the relevant arena of competition. A SSNIP test can help determine whether the alternative service offerings identified by WWNZ meaningfully belong within the same market as supermarkets.

2.1 Applying the SSNIP test

Service offerings compete in the same market if they are sufficiently close substitutes, either by being demand-side substitutes or supply-side substitutes. We focus here on demand-side substitutes.[2] While the Commission is not required to conduct a market definition exercise as part of a market study, the use of market definition tools such as the SSNIP test can be useful to understand which alternatives to supermarkets are relevant to examine in more detail.

A SSNIP test can help establish whether two service offerings or products compete in the same market. It is used to define the smallest possible market within which a hypothetical monopolist could profitably increase prices.

In the context of the retail grocery market, a SSNIP test can establish whether a 5 percent increase in supermarket prices leads to sufficient substitution to alternatives to make the price increase unprofitable. If meaningful substitution does not occur, then the product compared does not belong within the defined market. The test can be applied empirically.

Given that the Commission is currently at the stage of seeking feedback on submissions for the purposes of identifying issues that the Commission should consider in the market study we apply the test only at a conceptual level, rather than empirically. To apply the SSNIP test empirically requires information on profit levels and elasticities.

2.2 Value-added services are irrelevant to competition for grocery retailing

WWNZ claims that the total retail grocery market includes food and beverages services (in other words restaurants, takeaways and deliveries), which claim over 25 percent of retail food supplied in NZ.

Value added services such as restaurants provide a ready-to-eat good, reflecting restaurant specific skills and additional inputs to supply. This is a very different good to that offered by supermarkets.[3] If a hypothetical supermarket monopolist increased the price of products by 5 percent, very few consumers (if any) would respond by shifting their consumption towards restaurants.

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[2] Supply-side substitution occurs when a supplier of another good or service is able to readily switch capacity to supply of the good or service offered by the hypothetical monopolist. We think it is unlikely that supply-side substitution would occur in response to a SSNIP by a hypothetical monopolist that supplied the full range of supermarket goods.

[3] Of course supermarkets do offer ready to eat food options, but this likely accounts for a very small percentage of total sales.

2.3 Premium food subscription services likely fall outside the relevant market

WWNZ and Foodstuffs claim they compete with premium food subscription services such as Hello Fresh and My Food Bag.

Food subscription services offer a premium convenience product appealing to time poor households, which is likely to appeal only to a segment of supermarket consumers.

We do not consider that these services will pass a SSNIP test. If supermarkets increase their prices by 5 percent, consumers are unlikely to shift their consumption towards food subscription services at a scale that makes the price increase unprofitable for supermarkets.

2.4 Convenience stores fall outside the relevant market

WWNZ claims that convenience stores, including service stations and dairies, are another source of competition for supermarkets. FSNI's submission describes the retail market in terms of customer missions ranging from impromptu missions to purchase a single item, through to full-shop missions representing a traditional weekly trolley shop. It argues that missions have been changing, and that as customers move increasingly towards smaller scale shops, alternatives including convenience stores, exert more competitive pressure on the supermarkets.

While there may be a marginal effect, we would not expect that convenience stores materially constrain the behaviour of supermarkets. Observed movement towards greater purchasing from convenient stores does not mean there is greater pressure on supermarket prices, and instead may simply reflects changing preferences.

Convenience stores typically retail their product at a significant premium to supermarket prices.[4] Many small convenience stores purchase their products from supermarkets, and so are unable to compete with supermarket prices. Convenience stores also provide a limited range of products.

Applying the SSNIP test, if a hypothetical supermarket monopolist increases prices by 5 percent, consumers are unlikely to switch a sufficient amount of purchases to convenience stores to make the price increase unprofitable. We hold this view largely because of the price premium faced by consumers in convenience stores, but also because of the limited product range.

2.5 Purchase of individual grocery types from specialist suppliers is generally unlikely to be a sufficiently close substitute for full-service supermarkets

As discussed above, FSNI expresses the view in its submission customer purchasing patterns are changing towards smaller scale shopping missions. It takes the view that specialist suppliers exert more competitive pressure on supermarkets as a result of these changes.

The range of services purchased in each mission, rather than the size, is likely more relevant to whether specialist suppliers provide competitive constraint on supermarkets. For example, if

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4 We note that some convenience stores such as 4 Square and On the Spot are owned and supplied by Foodstuffs which limits competitive pressure from these sources.

consumers are still purchasing a selection of items from different product categories, then specialist suppliers (such as butchers, fruit and vegetable shops, and direct to customer vendors) are less likely be an alternative to small supermarket missions.

Our hypothesis is that small scale convenience stores will not pass a SSNIP test. If supermarkets increase their prices by 5 percent, we do not think consumers will substantially substitute their supermarket shopping for specialist retailers. We think this because these alternatives fail to substitute for the trolley shop. Despite the existence of alternatives, these alternatives are not effective substitutes due to associated transaction costs (time, and possibly transport costs) of recreating a full shop using supermarket alternatives.

Undoubtedly, some consumers will shift towards specialist shops, however, we do not think this behaviour shift will be significant enough to change the behaviour of supermarkets. This will however depend on the product and geography. For example, WWNZ refer to Horticulture NZ's estimate that independent "fruit and vege" retailers are represent 60 percent of sales of fresh fruit and vegetables in Auckland. In the same article, Horticulture NZ also say that nationally supermarkets sell 80 percent of fresh fruit and vegetables.[5] These estimates indicate that the competitive pressure varies within different areas of NZ by product category.

Information that may help the Commission confirm the extent of competitive pressure that speciality supply places on supermarkets includes: the value that consumers place on convenience, the cost that consumers would face in purchasing from specialised suppliers, and the range of products that customers typically purchase when shopping at a supermarket for large and small missions.

3 Economic profits, rather than accounting profits, are relevant to competition assessment

Understanding the profit margins of firms within a market can reveal insights about the state of competition within a market. Persistent excess profits can be a symptom of an uncompetitive market.

WWNZ states in its submission that it is a low margin business and that this reflects a highly competitive retail grocery sector. WWNZ supports this conclusion with information on accounting profits. However, economic profits, rather than accounting profits, are relevant to competition assessment. In other words, what is relevant is whether firm's return on capital is higher than a reasonable expectation of a required return.

We anticipate that the Commission will consider relevant profitability measures in detail as it did in the fuel market study, and then examine grocery retailers' profits using the measures it

[5] https://www.scoop.co.nz/stories/BU2008/S00204/open-letter-horticulture-recognise-independent-fruit-vegetable-retailers-as-essential-services.htm

finds to be appropriate. As a result, we do not examine profitability measures in detail in this report. However, we comment on the information that the Commission will need to collect to properly examine whether supermarkets are earning excessive returns.

3.1 Economic profit is the most important measure for competition analysis

WWNZ refer to a number of measures of accounting profit in their submission on the issues paper:

- Earnings before interest tax and depreciation and amortisation (EBITDA). EBITDA is gross profit minus the overheads (wages, transport, admin, electricity)
- Earnings before interest and tax (EBIT), which is the operating margin
- Net profit as a percentage of sales.

These accounting measures however do not factor in the real economic cost of doing business. They only measure the difference between a firm's revenues and operating expenses. To understand the true profitability of a firm in the context of examining the extent of competition that it faces, we need to understand its economic profit.

Economic profit is the excess return on equity over and above required returns. The required return is the return on an asset given the risk associated with the investment. It may be estimated using asset pricing models such as Capital Asset Pricing Model (CAPM). These required returns reflect the opportunity cost of investing.

Factors that lead to excess returns include technological advantage, pricing power and cost leadership. Over time excess returns are competed away as entrants seek to capture the same returns relative to invested capital. Sustained excess returns warrant attention as there may be barriers to competition.

Studying economic profits alongside pricing, profit margins and other quantitative and qualitative business factors can shed light on potential competition issues. However, we note that profit alone does not allow a definitive conclusion on market power. For example, low returns could reflect cost inefficiencies rather than a lack of competition. High returns could attract future market entry, depending on the extent of barriers to entry and expansion.

3.2 Woolworths' high returns in Australia may suggest excessive returns also exist in NZ

The lack of publicly available information on supermarkets that are members of the Foodstuff cooperative, and the absence of balance sheet information for WWNZ means that we cannot examine the return on capital for any of the NZ supermarkets participants. We note that Woolworths Australia's return on capital employed (ROCE) sat at 25 percent from 2017 to 2019. The reported ROCE fell in 2020 13.7 percent, but this change appears to be fully explained by a difference in the treatment of leases.[6]

These returns seem to greatly exceed what would be expected for Woolworths (a defensive company with a low asset beta) from a CAPM perspective, and do not indicate a strongly competitive market. NZ likely has less competition for retail grocery supply than Australia,

[6] Woolworths' Five-Year Financial Performance Summary

because Aldi and Costco are both currently active in Australia. Therefore, we suspect NZ grocery retailers' will have excessive returns on capital.

3.3 Further information is required to calculate returns on capital by NZ supermarkets

To investigate whether economic profits are being earned by grocery retailers in NZ, we recommend that the Commission collects financial information from WWNZ, and a broad sample of Foodstuffs' member supermarkets (across all banners, a ranges of locations and sizes), and the Foodstuff cooperatives. This information would need to include income statements and balance sheets, with sufficient detail to prepare consistent estimates of the ROCE.

The complicated structure of Foodstuffs may require a forensic study to understand financial flows. We recommend that this exercise must include a broad sample of stores from all banners.

For Woolworths, the Commission would also need to understand financial transfers and payments between the NZ operations and the Australian parent organisation.

4 International price comparisons must be carefully constructed and interpreted

WWNZ claims in its submission that New Zealand retail grocery prices are not high compared to other Organisation for Economic Co-operation and Development (OECD) countries. This is based on an international benchmarking analysis commissioned by WWNZ and conducted by NERA.

We find that the results produced by NERA are unreliable. In addition, they provide no insight into the extent of competition. At best, the NERA report raises some interesting methodological issues for the Commission to consider if it undertakes price comparisons.

Price comparisons that are used to screen for competition problems should be carefully constructed, to best suit that purpose. NERA's analysis raises methodological issues that should be addressed to produce a more meaningful indication of whether prices in New Zealand are higher than they should be.

We appreciate that constructing a full price comparison from scratch is a substantial exercise (and arguably beyond the scope of the current process of submitting on the Commission's Preliminary Issues Paper). However, a comparison that is not carefully constructed risks providing misleading results.

Moreover, while price comparisons can be useful to understand the position of New Zealand retail grocery customers relative to other countries, the results must be interpreted carefully. Price-cost margins are more relevant for competition analysis. Therefore, combining internationally price comparisons with insights on how costs are likely to differ can be more useful for examining the extent of competition.

4.1 Price comparisons used to screen for competition problems should be carefully constructed for that purpose

Methodological choices assist with answering the question of how the extent of competition in NZ compares internationally. For example, if we are looking at how prices paid by consumers for grocery products vary across countries, we would include taxes and excise taxes. In contrast, if we are looking at how competition varies across countries, we would seek to exclude taxes, as including these will distort the results of the price comparison.

Similarly, if we have a clear view on the purpose of the analysis, we can refer to this in making other methodological choices such as:

- Which collection of products to include
- What granularity of analysis to conduct, including whether we assess the results for product categories or in aggregate
- Which supermarkets to include
- Which geographic locations to include, both in terms of international comparators, and which locations within NZ should be included
- Whether to use market exchange rates, exchange rates that adjust for Purchasing Power Parity, or other exchange rate measures that may adjust for costs of supply.

These are the types of issues that the Commission would need to consider if it undertakes its own price comparison.

In what follows we make some specific comments on the methodology used by NERA in its price comparison.

4.2 Suitable comparator firms should be used

To construct its price comparison, NERA drew on the Economist Intelligence Unit's CityData tool which contains price data for 89 products spanning 140 cities. Product prices are divided by at least two categories:

- Supermarkets (which are supermarkets or equivalent high-volume outlets)
- Mid-priced stores (which are mid-priced stores or equivalent middle-market retail outlets).

PAK'nSAVE was measured in the supermarkets category, and Countdown, New World, and Farro Fresh was measured against mid-priced stores. We were not able to determine—either from the NERA analysis, or the CityData tool—the criteria for including a store in either category.

Therefore, the results of the price comparison may mis-represent the affordability of some New Zealand stores relative to overseas stores. For example, if the 'mid-priced stores' category includes prices from boutique and specialist food retailers, this may push up international prices, thereby presenting New Zealand as more affordable. While NERA sought to address this by creating a blend of the supermarket and mid-price store category it is not clear that this technique provides a meaningful comparison either.

We recommend that any price comparison provide clear transparency on what methodology is used so that all parties can satisfy themselves that suitable comparisons are being made.

4.3 Choice of comparators and treatment of metro and urban locations

NERA relies on a dataset of OECD cities. Some cities (including Auckland, Sydney and Melbourne) are considered metro and others (including Wellington, Perth and Adelaide) are categorised as non-metro. Neither we, nor NERA, were able to clarify definition of metro and non-metro locations. In any case, the comparison focuses on cities, and does not provide insights on prices in other areas where competition may be more limited.

4.4 Analysis by category may be more useful than an aggregate view

NERA assessed a basket of goods and presented aggregate results. It also presents the results limited to the categories that the Commission proposes to include in the market study.

Further disaggregating the results by product category may be more useful for the purposes of interpreting the results. For example, some categories such as fruit and vegetables are likely to be lower cost in NZ relatively to many of the other benchmark cities, as these generally are locally supplied in NZ. For categories where product is commonly imported by NZ supermarkets, the cost of supply in NZ may be expected to be more expensive.

4.5 Interpreting the results of price comparisons

Ultimately the purpose of a price comparison for a market study is to assist with understanding whether competition is likely to be more or less intense in NZ than in other countries. A comparison that focuses purely on price may provide a “red flag” approach identifying whether a country performs worse than would be expected.

However, results should be interpreted with reference to likely differences in cost across countries. NERA (and WWNZ) does not attempt to interpret the implications of the price comparison results for competition and rightly notes the complexities. Without this, however, NERA’s price comparison does not meaningfully contribute to the analysis of whether supermarkets in NZ face strong competitive pressure.

5 Private labels

As WWNZ, FSNI, and FSSI point out, private labels can bring benefits to consumers through increased product variety, and can also increase competitive pressure on suppliers which could lead to lower prices for consumers. However, as highlighted Consumer NZ and FGC, the growth of private labels could potentially lead to a loss of consumer choice and higher prices over the longer term.

Key questions for the Commission to consider in its market study include:

- Whether potential consumer benefits will be sustained over the longer term
- Whether growth in private labels will increase consumer choice, or instead reduce consumer choice
- Whether the extra buyer power gained by the supermarkets has a beneficial effect – for example, does it provide a beneficial effect through strengthening countervailing buyer power to address market power in supply markets, and do the benefits flow to

consumers? Or, does it result in extremely unbalanced power in favour of supermarkets, and if so, does that adversely affect consumer outcomes?

Importantly, the Commission needs to carry out its analysis of these types of questions in the specific context of the relevant markets in NZ, given:

- The structure, concentration and degree of market power in the relevant retail grocery market
- The incentives on grocery retailers in NZ, given their ownership and operating structures.

5.1.1 Conclusions on private labels from other countries may not be applicable in NZ

The effects of private labels on consumer outcomes may vary according to the level of concentration in the retail market. For example, if a supermarket sells a private label and reduces the range of brands available to consumers, the impact on consumers will differ according to the other supermarket options available. If there are a number of competing supermarkets, consumers have the option to purchase other brands from those other supermarkets. In a more concentrated market, consumers have less options, and so private labels may affect outcomes differently.

5.1.2 The ownership and operating models in place for NZ supermarkets may alter incentives

The arrangements for supply of private label products by supermarkets in NZ may affect incentives to promote those products relative to competing products. These arrangements include:

- The agreements between WWNZ and its parent company, under which WWNZ supplies private label products, including management incentives, and
- The agreements between FSNI, FSSI and their respective cooperative members for supply of private label products, including incentives.

These agreements may, for example, contain incentives to sell certain volumes of the private label products, or requirements to promote private labels products in certain ways. These contracts or arrangements are important to understanding whether supermarkets in NZ are likely to have incentives to favour private label supply, over the supply of competing products. For example, supermarkets may have incentives to favour private labels by providing preferential access to premium shelf space, applying a lower margin to private labels than to other products, providing advertising or promotion opportunities that aren’t available to other products, or applying charges to competing suppliers but not requiring the private label to contribute towards those costs. We recommend that the Commission gather information on the arrangements between Foodstuffs supermarkets and the cooperative, and between WWNZ and its parent company, regarding private label supply to better understand the supermarkets’ incentives and the implications for market outcomes.

In summary, NZ supermarkets may have quite different incentives than those of a single vertically integrated entity, that affect behaviour in supplying private labels, and market impacts. As a result, the Commission will need to be careful to examine private label effects in the specific context of NZ. Observations from other countries or from economic models may not necessarily be applicable to the NZ circumstance.

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