Market study into the grocery sector

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Personal background

I am a senior lecturer in the Department of Marketing, University of Otago. I teach and research in food and fast-moving consumer goods marketing and low involvement (quick decision) consumer behaviour. I was originally trained in agricultural science and worked in the UK pig industry for a number of years before moving into academics. As supermarkets are central to food marketing, they have been a particular focus of my research and teaching for over 30 years.

Summary

While the current Commerce Commission material on the subject above covers many points, a couple of important aspects of how supermarkets work do not feature as much as they should. Having thought for many years upon how the more negative aspects of supermarket behaviour might be moderated, I would like to make the following suggestions:

1) Retail

The basic nature of food markets means that nearly all unregulated channels of food distribution will contain a dominant channel captain, which will tend to distort pricing to the detriment of other channel participants. At the moment in New Zealand, the channel captains are retailers, but attempts to weaken them will simply lead to the emergence of other powerful channel players, and the re-emergence of the same behavioural issues.

I would therefore suggest that supermarkets are allowed to remain as the dominant player in food channels under private ownership, but that they are regulated as public utilities. The prime components of such regulation would be:

a) that supermarkets do not engage in wholesale or manufacturing activity
b) that individual supermarket sites could only charge a single fixed and publicly stated margin on all the goods that they sell in their stores. This margin is set to create a reasonable rate of return on capital.

2) Wholesale

While it is not as visible, the level of ownership concentration at food wholesale, and some points of food manufacturing (eg. slaughtering with meat and day-old chicks for chickens) is approaching or even exceeding that seen in retail. It should be noted that Foodstuffs is not only a dominant retailer in its New World and Pack ‘n’ Save formats, but as Trents it is also a dominant wholesaler. This concentration at wholesale is allowing Trents, and other wholesale operations like it, to capture an increasing proportion of the profitability of non-retail food sectors such as food service. The primary outcome of this – a lack of difference between supermarket retail and wholesale prices for food products is noted in the Commerce Commission’s materials.

Food service has proved to be resistant to concentration at retail level, but as a consequence of this it is highly vulnerable to concentration of ownership at the wholesale level. I do not suggest that wholesale operations are regulated as public utilities, but the following regulations (in addition to the prohibition of wholesale/retail vertical integration noted above) would address many of the issues that this concentration causes. These regulations are pertinent because the regulated retail margins suggested above will only be effective if the retailers cannot demand excessive and/or exclusive discounts from their suppliers.

a) That, for any particular product, no discounting or any other related price discrimination mechanism between individual buyers is allowed.
b) That a wholesaler cannot decline service to any buyer at that price, unless they can demonstrate that the goods in question are not available and cannot be procured.

3) Enforcement

These are simple regulations, and they are meant to be so, for simple regulations are enforceable ones. In addition, infringement of them can be clearly and directly observed by all chain and market participants without the need for tiresome financial analysis based on information that would have to be procured (with difficulty) from the infringers themselves.

The key to any effective regulation is timely enforcement that inflicts penalties that cannot be considered merely as a 'cost of doing business'. I thus make four further suggestions:

a) That infringements are treated as 'per se' offences – This means that the crime is committed simply by infringement – no harm to third parties has to be proved.

b) That legal action can be taken against infringers not only by the supervising entity, but also by any private citizen, body corporate or agency of local or national government.

c) That the supervising government entity is not an autonomous organisation, but is an integral part of a ministry that answers directly to a minister of the Crown.

d) That penalties are significant ($100,000+), and are not levied against organisations, directors or shareholders, but are levied directly and personally against the executive officers with ultimate executive responsibility for the infringing activity. This means the CEO or executive owner of the concern. Insurance against such penalties should be forbidden.

Commentary

This whole investigation was triggered by the excessive prices charged by New Zealand supermarkets. The Commission's report is somewhat 'light' on how pricing is manipulated by supermarkets, not only in New Zealand, but around the World.

It is critical to appreciate that the strategic unit of the supermarket trade is the <u>category</u>. A category can be thought of as an entry on the average consumer's shopping list e.g. meat/fish/butter/eggs/chocolate/cheese/coffee'. The consumer has planned to buy these categories before they arrive at the store – but typically they have not yet determined what products out of each of these categories they will buy. The average supermarket has between

200 and 250 separate categories. The supermarket is a highly sophisticated machine that is designed to make the consumer pay the maximum amount that they can be persuaded to pay within each of these categories on each visit. Price is just one of the tools that they use. Let us see how:

KVI's

Most people have a strongly held opinion on which supermarkets are cheapest. But what is the evidence upon which these opinions rest? The average supermarket has around 30,000 stock keeping units (SKU's). Thus, if you were to do an accurate price comparison of New World Pak 'n' Save and Countdown, you would need to know the price of around 90-100,000 items. This task on its own is hard enough, but if you went into any of these stores and started taking detailed price notes you would last about two minutes before you were challenged and kicked out (ask me how I know). As a result, nobody knows which supermarket is cheapest, or if they are actually any cheaper than the independent greengrocers and butchers in the area.

In the absence of actual knowledge, people make estimates based upon the prices of a handful of the products that they do (vaguely) know the price for. Luckily for the supermarkets most people only know this for a few items, and those items tend to be the same ones. There are about 40 of them, and these are referred to as 'known or key value items' (KVI's). So, two litres of standard milk is a KVI, but one and three litres are not. A 454g tin of baked beans is a KVI, but 200 and 600's are not, and so on. Identifying KVI's is a relatively straightforward matter – just see what is relentlessly and publicly price promoted by the supermarkets. Clearly this means that the margins on KVI's is very low indeed, but once the impression of cheapness is formed via these 40 or so KVI's the supermarket is free to charge very much higher margins on the remaining 29,960 SKU's that they sell, while exploiting this consumer 'halo' effect of cheapness.

High and low margin categories.

The areas where very high margins are charged by supermarkets can be identified by taking a walk around a store. Figure 1 shows the layout of three stores in Dunedin. The green areas are where the higher margins are set, and significant profits are made. These areas include categories such as: fresh fruit/veg., bakery, deli, meat, fish etc. These areas are pleasant, and are laid out in a way that slows you down – what is known as a 'swirl' pattern. You are encouraged to stop, meander, ponder and buy. The grey areas are where the goods with lower margins are stacked – and these are not so pleasant. The emphasis is on efficient selection and fast throughput in these areas of essentials that the supermarket has to stock, but has less fiscal interest in.

In most formats the consumer is persuaded to follow the red track, which represents the path of maximum profitability for the supermarket. This persuasion is a highly sophisticated process. To take but one example - note that all of these red routes are counter clockwise – In this country we drive on the left, walk on the left and therefor have a slight, but valuable tendency to be more comfortable turning to the left. Only the oldest supermarkets in Dunedin are not set up for this 'left hand drift'. Some stores, where they can get away with it, dispense with persuasion and use a force-flow pattern. The Pak'n'Save (South Dunedin) layout is an example of this. The small 'rat run' which bypasses the high margin section is a relatively recent addition. Before that went in, you *had* to follow the path through the high value sections. In one supermarket chain 'Franklins at Big Fresh', this split section layout was taken to the point that the two areas were branded separately: Franklins (low margin) and Big Fresh (high margin) with a forced flow layout. It turned out to be a step too far and that player is no longer with us.

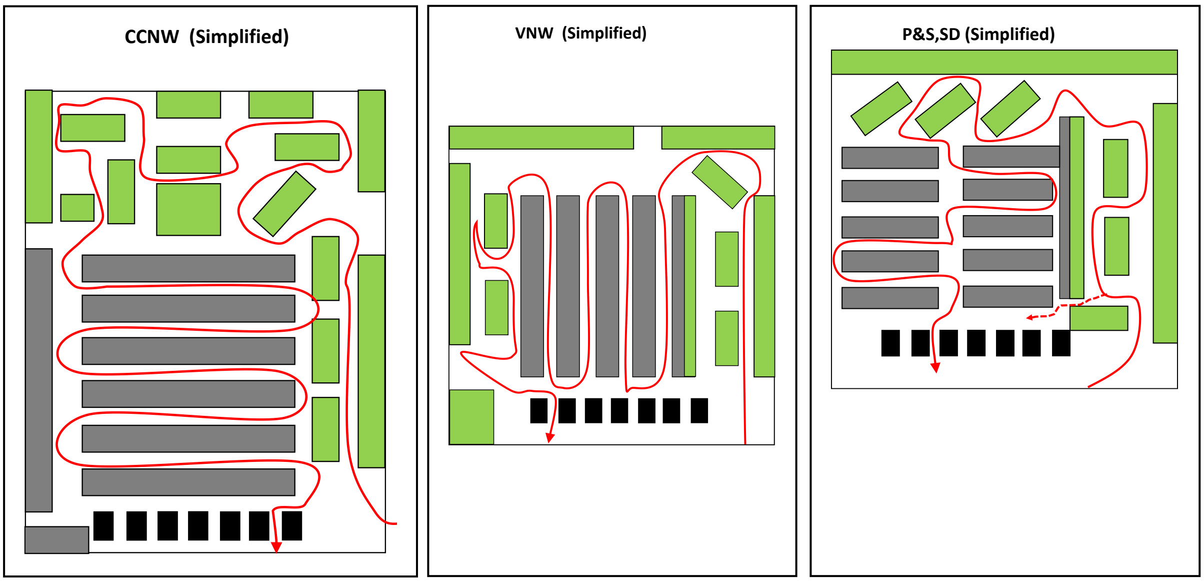

Figure 1: The three major Foodstuffs stores in Dunedin - Centre City New World (CCNW) Valley New World (VNW) and Pack'n'Save' South Dunedin (P&S SD)

Any shopper who compared prices in these high margin areas with those charged by independent retailers might be surprised by the outcome. As far as I am aware the only public price survey of this nature was undertaken by the BBC for a 'Panorama' documentary during a similar investigation of supermarket pricing by the British government in 2000. The reported outcome was that price charged by the four big UK supermarkets for meat, fruit and vegetables was consistently and significantly above that charged by small local independent retailers.

It is regrettable that this is so, given that the goods that are in high-margin areas are those that all the agencies responsible for public health are saying we should eat more of. This system also masks both seasonal and longer-term signals in fresh goods that would allow such markets to clear more efficiently, to the benefit of both producers and consumers.

Long term category price structures

One of the first things that I teach in my food marketing classes is that the category is the prime strategic unit of retail food marketing, and thus the prime strategic unit of all food marketers, given that retailers run the show. All other activity, at all levels of the food industry, is directly or indirectly subordinated to the objective of maximising retailer returns within the category. The Commerce Commission's material notes a lack of price competition *between* supermarkets. It is important to also appreciate that there is very little price competition *within* supermarkets either – at least with regard to what the consumer is offered and what they pay. Categories are run by supermarkets to maximise the profit (for the supermarket) generated by that category. The range of products and brands that are available within that category are simply units that are deployed exclusively by the retailer and at the retailer's pleasure towards that end.

In a typical supermarket category one item (e.g. 454g baked beans) may have three independent brands (Heinz, Watties and Oak), and two retailer (house) brands (Pams and Value). These items look like they are competing, but they are not in any natural manner. The house brands make high margins for the retailer, while the independent brands drive innovation and consumer interest while returning adequate margins. The independent brands are allowed to survive because retailers know perfectly well that they cannot match the collective capacity of their suppliers to innovate, and market and thus drive the category. The net purpose of this is to ensure that per individual purchase, averaged over millions of such purchases, the consumer pays more for a 454g tin of beans than they otherwise would do.

On an aside, this is why discounters such as Aldi or Lidl are destructive to full-service supermarkets such as Woolworth and Tesco. The discounter model is that they have only one house branded product (e.g. 454g of beans) of any product type available. It's a 'take it or leave it' offer to the consumer. However, this format eliminates all the expensive pseudo competition noted above and thus reduces the non-core offer costs of the discounter's offer to an absolute minimum. This means that the 454g tin of Aldi beans is almost always better value than any of its full-service supermarket alternatives – which means that large number of consumers do choose to take it.

The discounter, however cannot innovate to any great degree because it lacks the capacity that is provided by independent brands to do this. Discounters therefore rely on the full-service sector to generate this innovation – which they then copy if it's worth it. They therefore do not actually compete with full-service supermarkets; they *prey* on them in a controlled manner. This is why discounters do not represent a long-term solution to the full-service supermarket duopoly problem in this country.

Short term price structures

If one was to ask somebody what the most powerful food brand in New Zealand they might come up with an answer like 'Coca-Cola'. They would be wrong. The most powerful food brand is almost certainly 'Super Saver' a red and yellow branded price discounting system that belongs to Foodstuffs. Unlike Coca Cola, which has a significant impact in one or two categories, Super Saver significantly affects consumer choice in almost every one of the 200+ categories that the average New World store deploys. Our own research indicates that consumers will prefer Super Saver branded products even if discounts offered under other formats are considerably greater.

It is debatable as to whether Super Saver and systems like it actually benefit consumers over the long term as it is itself one item within a portfolio of brands and price structures that is under the control of the retailer, and that is used for the purposes of maximising retailer return within the category. For example, if one item of every five in a category is on a branded 20% discount at any one time, the net benefit for the consumer to is zero if the base level price of the other four non-promoted items within the category is set 5% higher than it otherwise would be. There is, however, no doubt that Super Saver and all other short-term discounts (e.g. Club Deal and Every Day Value) increase the opacity of an already opaque pricing situation from the point of view of both the consumer and supplier.

The way forward

Over thirty years I have pondered this situation. To put it bluntly, for a supplier there is no money in food if you are not a supermarket, and for a consumer, food is expensive in this country to the point that places like Tokyo and Berlin seem ludicrously cheap. But how to deal with it?

I do not believe that breaking up the supermarkets represents a solution, as dominant players will appear elsewhere in the supply chain to take their place. These dominant players could well be overseas based. While Foodstuffs and Woolworth New Zealand look very big to us, it is worth remembering that they are small fry by the standards of the global food industry. Weakening them significantly could be a very unwise thing to do.

Likewise, I do not think that bringing in extra retail players will change matters. The UK for instance shows that retail dominance and competition suppression can be run with four or five players. Also, no new entrant will want to 'spoil the market' by competing meaningfully on price – and this includes discounters.

This leaves the option of regulation to moderate retailer behaviour – I do not for one minute believe that any code of conduct will make any difference. The fiscal motivation to cheat on it will find a way around it too quickly. This also applies to any framework that involved an 'independent' regulator. Given past experience, its rapid capture by those who it had been set up to regulate would be a foregone conclusion. It would then become an integral part of an exacerbated problem.

This leaves the law, and the proposals that I outlined above. Law is an unfashionable tool to address economic issues, but it has worked well before, and it will doubtless work again once the neoliberal era has run its course. There is nothing wrong with powerful retailers as long as they are <u>fully transparent to both suppliers and consumers</u>, and that power can then be used to the general public good. It is this issue of converting opacity to transparency that my proposals address. There is no reason why such regulated and transparent entities should not make a <u>reasonable</u> return on capital for an activity that is effectively risk free, and this may be the basis upon which a 'base' margin might be set by the regulating agency. What is a reasonable return? Well, not 20%+ as it is at the moment, according to the Commerce Commission's own figures. Maybe for any supermarket owner, a reasonable expectation of return might be the equivalent of winning Powerball once a career rather than once a year.