

# Memo re Houston Kemp comments of 3 December 2021

To: Commerce Commission  
CC:  
From: Frontier Economics  
Date: 23 December 2021  
Subject: **Houston Kemp Report dated 3 December 2021**



## Response to Houston Kemp submission

In their submission to the Commission,<sup>1</sup> Houston Kemp made a number of claims regarding the Frontier Economics analysis.<sup>2</sup> Some of these comments repeat material in their earlier document dated 9 September 2021. We have already responded to many of these comments. In this memo we respond to some matters raised in the Houston Kemp Report dated 3 December, to which we did not respond previously.

## Consideration of impact of competition on prices compared with margins

Houston Kemp observe that we were requested by the Commission to undertake an econometric analysis to test whether there is a relationship between concentration and price and/or margins in local grocery markets.<sup>3</sup> They further observe that our analysis was limited to the relationship between local concentration and prices.<sup>4</sup>

Our decision to concentrate on the effects on prices rather than margins was made at the beginning of our work on the project. The decision was prompted by two considerations.

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<sup>1</sup> Houston Kemp, Empirical evidence of grocery sector competition – further analysis, 3 December 2021 (Houston Kemp submission).

<sup>2</sup> Frontier Economics, Econometric analysis of the New Zealand Retail Grocery Sector, 25 June 2021.

<sup>3</sup> Houston Kemp submission, para 102.

<sup>4</sup> Houston Kemp submission, para 106.



In the first place, we were aware of the difficulties associated with using margin of price on marginal cost as a dependent variable. We referred to these difficulties in our proposal to the Commission and proposed that any analysis of margins should be confined to gross margins. The difficulties associated with obtaining measures of marginal costs are well known to industrial organisation economists.<sup>5</sup>

The second problem was associated with obtaining useful data on gross margins. Because of differences in the organisation of the two large grocery chains, we could not be sure that the costs used when calculating gross margins were comparable across the chains.

## Consideration of non-price elements

Houston Kemp observes that the analysis did not account for non-price elements of competition.<sup>6</sup>

As seen in the cross-section regression results in Appendix A of the Frontier Economics report, we did consider the impact of each store's floor space on price indices and found that the results were mixed. In some regressions the coefficient on the floor space variable was not statistically significant, but in many regressions the coefficient was negative and statistically significant. This suggests that an increase in floor area may be associated with a reduction in prices. Thus, the impact of the floor area of a supermarket on pricing could reflect the scale advantage of larger supermarkets rather than a quality dimension whereby shoppers value a more spacious supermarket.

We also received data on staffing levels of supermarkets. In earlier iterations of the cross-section analysis, we did incorporate the staffing level. With the exception of [ ], this variable was not statistically significant in the regressions, and the inclusion resulted in minimal changes to the estimated coefficients on the variables of interest.

Hence neither floor area nor staffing levels seems to have an impact in the cross-section price regressions consistent with them reflecting the quality offering of supermarkets. Rather, it appears that area simply reflects the scale of the supermarket, while the staffing level also reflects the scale.

This is not to say that level of competition would not impact on the quality, range or service levels of the offerings provided by supermarkets; but rather that the variables available to us do not appear to measure these non-price dimensions of competition in a satisfactory manner.

## Alternative modes of competition

Houston Kemp suggest that our finding regarding the limited impact of local competition on prices, is consistent with alternative forms of competition. In particular, Houston Kemp claim that our finding that local market concentration has little or no effect on local prices is equally consistent with a number of alternative conclusions, including that:

- a) there is intense price competition at a national level between the major retailers;
- b) local and national grocery markets are subject to effective competition

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<sup>5</sup> For a survey of the literature, see Timothy F Bresnahan, "Empirical studies of industries with market power", Chapter 17 of *Handbook of Industrial Organization, Vol II*, ed by Richard Schmalensee and Robert D Willig, North-Holland (1989).

<sup>6</sup> Houston Kemp submission, para 95.



c) intense competition between major retailers and other retailers takes place on the basis of all aspects of the retail offer.<sup>7</sup>

As Houston Kemp acknowledge, it was not part of our brief to examine the first of these possibilities. However, our analysis did bear on the other two possibilities.

The second possibility raised by Houston Kemp is that local and national grocery markets are subject to effective competition. Our analysis was confined to local markets. Competition in local markets can come either from rivalry among established competitors or from new entrants. We examined the effects on prices of each of these forms of competition. We found that there was little systematic effect. This does not imply that there is no effective competition at a national level. However, we could find no evidence of effective competition at a local level.

The third possibility raised by Houston Kemp is that intense competition between the major retailers and other retailers takes place on the basis of all aspects of the retail offer. As we observed above, we attempted to account for competition on dimensions other than price. However, the data available to us did not enable us to account for these dimensions – except through the measures of size of store and number of employees.

Our study was driven by data and underlying economic theory. We conducted empirical tests for certain propositions making the best use of the data that were available. Paragraph 99 of the Houston Report states, in effect, that we should have tested other propositions. We did not conduct the tests that are suggested by Houston Kemp because either:

- (i) they were beyond scope – as in the case of national competition; or
- (ii) there were no data available – as in the case of the kinds of non-price competition they seem to have in mind.

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<sup>7</sup> Houston Kemp submission, para 99.