Private label products in retail grocery markets

A report for Foodstuffs

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1. Introduction

1. We have been asked to prepare this report on the effects of private label products in the grocery sector by the two Foodstuffs cooperatives, ie, Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI).

2. The context for this report is the market study into the retail grocery sector being undertaken by the Commerce Commission (the Commission) and the considerations arising in relation to the influence of private labels on bargaining power and ultimately outcomes for consumers.

1.1 Castalia's findings as to consumer outcomes

3. Following publication of the Commission's draft report, the New Zealand Food and Grocery Council (FGC) submitted a report prepared by Castalia on the effects of private labels on consumer outcomes in the retail grocery market and the implications for potential interventions in the grocery market.[1]

4. Castalia concludes that in the present context of the New Zealand grocery sector private labels are:[2]

> …likely to accentuate and entrench the strong imbalance of bargaining power held by retailers when negotiating with many grocery suppliers,

5. and that this:[3]

> …heightens the need for intervention to address the harmful consequences of buyer power abuse and to reduce barriers to competition for entrant retailers.

6. The purpose of this report is to review the assumptions and analysis underpinning Castalia's findings and to identify any shortcomings so that appropriate conclusions can be drawn about the effects of private label products.

1.2 Summary of findings

7. Our principal finding is that the single most important assumption underpinning Castalia's analysis – that suppliers face a strong imbalance of bargaining power when negotiating with many grocery suppliers – is no more than a broad contention made by reference to just one side of the bargaining relationship.

8. Castalia has not undertaken any analysis as to the degree of supplier concentration in the many different category-specific markets that are relevant for the acquisition of grocery products by retailers. Accordingly, Castalia has no empirical basis by which to contend that strong imbalances of bargaining power are prevalent in any grocery category, including those for which private label products are more likely to emerge.

9. Several other assumptions underpinning Castalia's analysis are also either overstated or have no empirical foundation. These include that:

    a. the high combined market share of the major grocery retailers indicates that suppliers have limited options in relation to retailers to which they can supply their products;

[1] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

[2] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

[3] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

b. retail competition is not effective in the grocery sector and therefore private labels will have negative effects for markets and consumers; and

c. the evidence suggests that supplier price reductions that result from private label introduction would not be passed through to consumers.

10. Consistent with the unsatisfactory basis for Castalia's findings, we find there is no systematic evidence that private label products are or can be expected to have negative consequences for consumers in New Zealand's retail grocery sector.

1.3 Structure of this report

11. Our report is structured as follows:

a. in section two, we describe the key findings in Castalia's report and the basis for those findings;

b. in section three, we assess the critical assumptions underpinning the conclusions drawn by Castalia and their shortcomings, and explain that private label products are unlikely to have a detrimental effect on consumers in the grocery sector in New Zealand; and

c. in section four, we address the economic basis for the FGC's contention that there is an inherent conflict of interest when retailers offer private label products.

2. Castalia's key findings and their bases

12. In this section, we describe the key findings of the Castalia report, and the basis for those findings.

13. Castalia was asked by the FGC to prepare a report on the impact of private labels on consumer outcomes in the New Zealand retail grocery market and the implications for potential interventions in the retail grocery sector.[4]

2.1 Castalia's key findings

14. Castalia's key findings are that:

    a. the market context determines how private labels affect consumer outcomes – Castalia states that private labels are neither categorically positive nor negative for consumers, with the effect of private labels being dependent on how they alter the bargaining relationship between suppliers and retailers;[5]

    b. the effect of private labels on consumer outcomes is largely determined by concentration in 'the retail market', ie:[6]

        i. in unconcentrated retail markets, private labels are likely to have sustained positive impacts for consumers over the long term; whereas

        ii. in highly concentrated retail markets, private labels accentuate retailers' strong buyer power;

    c. New Zealand's grocery retail market is concentrated, allowing the major grocery retailers to have strong buyer power; and

    d. consequently, private labels will likely negatively impact New Zealand consumers over the long term, with Castalia concluding that:[7]

> Given the high concentration of the retail market in New Zealand, we find that private labels are likely to accentuate and entrench the strong imbalance of bargaining power held by retailers when negotiating with many grocery suppliers.

15. Overall, a close read of Castalia's report shows that much of the analysis underpinning its findings is tentative or highly conditional, implying that it does not have a strong empirical basis. For example, Castalia states that:

    a. 'In a highly concentrated retail marker [sic], **retailers may discriminate in favour of their private [label] goods** to maximise their margins' [emphasis added];[8]

    b. '**[c]onsumers may benefit** from lower prices initially for the private label, but these will **not necessarily endure** as the private label becomes established' [emphasis added];[9]

[4] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 6.
[5] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 6.
[6] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.
[7] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.
[8] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.
[9] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.

c. '**suppliers may be disincentivised** to invest in product innovations due to the risk that **retailers may use suppliers' innovations in their own private labels'** [emphasis added];[10] and

d. **'[i]f private label sales in New Zealand continue to grow** to the levels seen internationally, consumers would face **little choice and poor outcomes, given the high retail concentration** in the New Zealand market' [emphasis added].[11]

16. Notwithstanding the tentative or conditional nature of these statements, Castalia is more definitive in its statements as to relevant remedies in relation to private label products, stating:[12]

> Mechanisms **are required** to effectively address buyer power abuse, and to address strategic barriers to entry… [emphasis added]

17. FGC has also subsequently contended that there is an 'inherent conflict of interest' when retailers provide private label products, stating:[13]

> … in a highly concentrated market like New Zealand's there is harm that arises from the inherent conflict of interest where suppliers deal with their customer who is also a competitor.

2.2 Assumptions underlying Castalia's findings

18. Castalia's findings are based a number of important, underlying assumptions. These are that:[14]

a. the two largest grocery retailer groups hold a strong imbalance of power in the retailer-supplier relationship;

b. the high combined market share of the major grocery retailers indicates that suppliers have limited options in relation to retailers to supply their products;

c. retail competition is not effective in the grocery sector and therefore private labels will have negative effects for markets and consumers; and

d. the evidence suggests that supplier price reductions that result from private label introduction would not be passed through to consumers.

19. In our opinion, there are substantial shortcomings in these assumptions.

20. First, although Castalia acknowledges that the potential for poor consumer outcomes arising in relation to private label products derives from a strong imbalance of bargaining power, its analysis of the factors governing the balance of bargaining power as between suppliers and grocery retailers focuses on just one side of that bargaining relationship, ie, grocery retailers alone.

21. Second, several of Castalia's assumptions in relation to the buyer power held by major grocery retailers are of doubtful veracity. For example, additional evidence has been brought before the Commission in relation to the retail market constraints imposed on major grocery retailers,[15] thereby lessening the significance of market concentration, and that there is no basis to conclude that supplier cost reductions are passed through less thoroughly to consumers.[16] Both these forms of evidence cast doubt on several of Castalia's underlying assumptions.

[10] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.

[11] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 14.

[12] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.

[13] Commerce Commission, Day 7 - Retail grocery market study conference, Transcript, p 29, lines 36-38.

[14] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, pp 3, 4,10-11.

[15] See: FSNI, *Foodstuffs North Island post-conference submission on the grocery market study draft report*, Appendix A.

[16] See: HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021, p 29, para 148.

22. In the next section, we assess the veracity of the assumptions underpinning Castalia's findings and discuss the implications for Castalia's conclusions in relation to private label grocery products.

3. Critical assumptions and their shortcomings

23. Castalia's finding that private label products are likely to have a net negative effect on the New Zealand retail grocery market turn on its assumptions that:[17]

    a. the two largest grocery retailer groups hold a strong imbalance of power in the retailer-supplier relationship;

    b. the high combined market share of the major grocery retailers indicates that suppliers have limited options in relation to retailers to supply their products;

    c. retail competition is not effective in the grocery sector and therefore private labels will have negative effects for markets and consumers; and

    d. there are a large number of suppliers for each product with limited bargaining power.

24. We assess each of these assumptions below and explain their shortcomings.

3.1 Imbalance of bargaining power cannot be presumed

25. Castalia acknowledges that central to its findings in relation to the potential for poor consumer outcomes to arise in relation to private label products is the existence of a strong imbalance of bargaining power, as between suppliers and grocery retailers.[18] Notwithstanding, Castalia's analysis of the factors governing the balance of bargaining power as between suppliers and grocery retailers is largely confined to just one side of that bargaining relationship, ie, grocery retailers.

26. Castalia states that New Zealand grocery retailers source their products from many suppliers, providing retailers with strong outside options and bargaining power.[19] As such, Castalia assumes that there is low concentration in all relevant markets for the supply of grocery items to retailers, ie:[20]

> New Zealand grocery retailers source their products from many suppliers. Most of these suppliers sell less than $1 million of their product in a year. Due to the number of suppliers, retailers have a strong outside option which gives them buyer power. If a retailer does not secure a contract with one supplier, it can seek out a competing supplier.

27. In stating that retailers have strong outside options 'due to the number of suppliers', Castalia does not distinguish between suppliers of different grocery products. Although there may be numerous suppliers across all grocery items, it does not follow that there is low concentration in relation to the supply of any individual grocery product or across a grocery product category. Rather, the large number of suppliers is more likely to be a simple reflection of the large number of grocery items. Castalia's observation as to the existence of many suppliers cannot inform the extent to which, in fact, there may be high concentration in the supply of many grocery items.

28. The significance of this question is reinforced by the existence in New Zealand of a number of large global suppliers that each serve substantial proportions of the grocery supply market, including Unilever, Coke and Goodman Fielder.[21] Such large suppliers are much more likely to be able to provide products at lower cost and in the quantities required than small independent suppliers, as well

[17] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, pp 3, 4, 10-11.

[18] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

[19] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11.

[20] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11.

[21] Foodstuffs North Island, Post-conference submission on the grocery market study draft report, 3 December 2021, Section entitled, 'Pricing and terms of supply'.

as to supply branded products that are sought-after by consumers. In such circumstances, grocery retailers cannot be presumed to have strong outside options and so strong buyer power as contended by Castalia.[22]

29. For Castalia validly to conclude that high concentration in the retail market implies a presumptive imbalance in bargaining power in the supplier-retailer relationship, it would need to undertake an assessment of the degree of concentration that exists among suppliers of major grocery product categories. However, Castalia has not undertaken any such assessment.

30. This requirement stems from outcomes under the bargaining framework adopted for this purpose by the Commission – a framework that we agree is appropriate – being governed not only by the circumstances of grocery retailers but also by the bargaining circumstances of suppliers. However, Castalia has not undertaken any such assessment but instead refers only to the total number of suppliers across the entire retail grocery market.

31. In our opinion, by overlooking the potential countervailing bargaining power of suppliers, Castalia makes a presumption as to the buyer power of grocery retailers that has no empirical foundation. By consequence, none of the conclusions drawn by Castalia as to the likely effects of private label products on outcomes for consumers can safely be accepted.

3.2 Suppliers' outside options are under-recognised

32. Castalia assumes that the high combined market share of the major grocery retailers indicates that suppliers have limited options in relation to retailers that will supply their products.[23] On this assumption, Castalia suggests that there is an imbalance of bargaining power in favour of the major grocery retailers, even before considering the effects of private label.[24]

33. In our opinion, Castalia overstates the bargaining power of the major retailers by overlooking the extent of outside options available to suppliers, in the form of other, non-supermarket retailers.

3.2.1 Bargaining power of suppliers and retailers is dependent on outside options

34. Castalia states that grocery retailers already have a strong position of buyer power, which would be exacerbated by the introduction of private label products.[25]

35. Castalia draws on the Commission's finding that grocery retailers and suppliers typically enter bilateral supply agreements that require the parties to use their bargaining power to negotiate terms of supply.[26]

36. Under a bargaining framework, the bargaining power of each party will depend on their outside options, ie, the next best alternative for a party if negotiations were to fail. A party has more bargaining power if it has a better outside option. For example:

    a. if there are a small number of retailers, then the value of the outside options for a supplier that depends on the grocery channel to sell its products will be less, resulting in relatively low bargaining power as compared with a market that involves a greater number of retailers; and

    b. if there are a small number of suppliers of a particular grocery product and of any relevant substitutes, then the value of the outside options to a retailer will be less, resulting in relatively

[22] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 10.

[23] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11.

[24] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11.

[25] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 12.

[26] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 6.

lower bargaining power as compared with a market with many suppliers of substitutable products.

37. We agree with Castalia that the introduction of private label products increases the outside options for a retailer, and thereby increases a retailer's bargaining power.[27]

3.2.2 Suppliers have stronger bargaining power than assumed

38. Castalia states that suppliers have limited outside options on the basis of the Commission's finding that major grocery retailers are duopoly and account for the majority of the retail market in New Zealand.[28] However, we explained in our report[29] accompanying Foodstuffs' submissions to the Commission's draft report that the Commission's duopoly finding in relation to the major grocery retailers is a consequence of its focus on a main shop. In contrast, the results of the Commission's survey and IPSOS report suggest that, in addition to the major grocery retailers, consumers shop across a range of other stores.

39. It follows from these observations that suppliers are not limited to selling to the major grocery retailers, implying that they have stronger countervailing bargaining power than would apply in a strict duopoly market.

40. Moreover, private labels increase a retailer's bargaining power, irrespective of the number outside options available to suppliers. A retailer's bargaining power improves following the introduction of a private label because of the increased number and value of alternative options available to them, which they can consider when negotiating with suppliers.

41. In our opinion, by assuming that the grocery sector is more concentrated and the major retailers subject to fewer constraints than much of the evidence would suggest,[30] Castalia overstates the existing bargaining power of retailers. Accordingly, Castalia's conclusion that private labels will exacerbate the negative effects of strong buyer power is unsafe.[31]

3.3 Private labels can have positive effects in retail markets

42. Castalia appears to assume that competition between grocery retailers is not effective because the market is heavily concentrated.[32] It cites the Commission's conclusion that 'price competition between the major grocery retailers is considerably less than we would expect to see in a workably competitive market'.[33]

43. On this basis, Castalia assumes that private labels are likely to have a net negative effect in the grocery sector in New Zealand.[34] It states that private labels will exacerbate retailers' buyer power and lead to reductions in product variety and increases in the general price of groceries.[35]

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[27] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 12.

[28] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, pp 3-4.

[29] HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021, p i, para 6.

[30] See: HoustonKemp, *Empirical evidence of grocery sector competition – further analysis*, 3 December 2021.

[31] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 12.

[32] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11.

[33] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para 5.115 in Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 11. In our two reports on the grocery sector, we explain that the empirical evidence relied on by the Commission is limited and its findings are consistent with the conclusion that competition is effective. See: HoustonKemp Economists, *Empirical evidence of grocery sector competition*, 9 September 2021, and HoustonKemp Economists, *Empirical evidence of grocery sector competition – further report*, December 2021.

[34] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, pp 10-11.

[35] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 10.

44. Castalia acknowledges that private labels are neither categorically positive nor negative for consumers, reflecting that:[36]

    a. private labels can increase the range of products available, incentivise innovation by suppliers and reduce prices due to competition between private label products and branded products; but

    b. private labels can reduce suppliers' incentives to invest and innovate if the use of private labels enables abusive and discriminatory practices through accentuated retailer bargaining power.

45. Nevertheless, Castalia states the net effects of private labels will likely be negative.[37]

46. In contrast, in the section below we explain that:

    a. the available evidence is consistent with competition between grocery retailers being effective;

    b. the improved bargaining power for retailers resulting from private labels can lead to lower prices for consumers;

    c. the effect of private labels on innovation is likely to be limited, since private labels are more common in homogenous products;

    d. the low level of private label penetration in the New Zealand grocery market indicates that retailers will continue to offer a range of branded products in line with consumer preferences, implying that negative outcomes are unlikely to arise; and

    e. cost savings are likely to be passed on to consumers as retailers compete for sales.

3.3.1 Available evidence is consistent with competition being effective

47. In our earlier report on the nature of competition, we explain the basis for our conclusion that:[38]

> …the available empirical evidence as to the nature of competition, the extent of promotions, the pass through of cost changes and the primarily national basis on which price competition takes place is all either consistent with or positively supports a conclusion that competition in the retail grocery sector is effective.

48. In a further report prepared in conjunction with this report, we examine further the empirical evidence and relevant theories as to the nature and intensity of competition in the retail grocery sector by the two Foodstuffs cooperatives, ie, Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI).

49. We find that the empirical evidence and relevant theories relied upon by the Commission do not provide unambiguous support for its conclusion that competition is less than would be expected in a workably competitive market, and that the evidence is equally consistent with the alternative conclusion that competition in the grocery sector is operating effectively.[39]

50. Retailers in an effectively competitive market have a strong incentive to provide customers with the products that consumers want at the lowest possible prices. It would not be in the interest of a retailer to reduce the sale of branded products that consumers preferred, since this would risk those consumers opting to use a rival store.

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[36] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

[37] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 10.

[38] HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021, p iv, para 18.

[39] HoustonKemp, *Empirical evidence of grocery sector competition – further analysis*, 3 December 2021, para 5.

51. Rather, retailers have a strong interest in procuring a range of products that are sought after by consumers at the lowest possible prices, and which are likely to include both private label and branded products, with the balance between the two turning on consumer preferences.

3.3.2 Improved bargaining power by retailers can lead to lower prices

52. We explain in paragraph 37 above that the introduction of a private label will increase a retailer's bargaining power irrespective of the number of retailers in the market.[40]

53. Such an increase in bargaining power is the principal basis for the acknowledged positive effect of private label products, ie, private labels compete with branded products, thereby delivering lower prices for consumers. It follows that the increase in a retailer's bargaining power associated with the introduction of private label products cannot be presumed to imply a negative outcome for consumers.

3.3.3 Effect of private label on innovation likely to be limited

54. Castalia says that the overall outcome for consumers will largely be determined by the level of concentration in the retail market.[41] In our opinion, this suggestion is overly simplistic.

55. Castalia suggests that in concentrated retail markets, the imbalance in bargaining power enables retailers to take advantage of research and development by label brands and discriminate in favour of their private labels.[42] As a result, Castalia states that private labels in concentrated retail markets can discourage supplier entry, investment, and innovation, to the detriment of consumers.

56. However, the effect of private labels on innovation in the grocery retail market is likely to be limited. Castalia acknowledges that private labels are most beneficial to retailers when they are a close substitute of a named brand.[43] As a result, private labels are more common in homogenous products that require limited innovation, such as flour and milk. In contrast, private labels are less prevalent in categories with high-innovation. For example, Coriolis Research states that:[44]

> Private label is most successful in categories with low-innovation by manufacturers. Therefore manufacturers who have successful created innovative product or packaging – Gillette's Mach 3 Razor, Tegel's Boneless Turkey Roast, and Masterfood's grinder-top on peppercorns – have created barriers to the entry of private label in their categories.

57. In any case, the conclusion that innovation is likely to be stifled is dependent on Castalia's assumption that retail markets are concentrated and thereby not subject to effective competition. We explain above that Castalia has overstated the level of concentration and understated the level of competition in the grocery sector.

3.3.4 Low levels of private label penetration indicate that negative effects are unlikely

58. Castalia states that although consumers initially may benefit from lower prices following the introduction of private labels, in concentrated markets these will not necessarily endure, as the private label becomes established.[45]

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[40] Assuming the retailer introduces a private label that is a sufficiently close substitute for a named brand.

[41] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 3.

[42] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.

[43] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 8.

[44] See Coriolis Research website, https://coriolisresearch.com/pdfs/200401_adworks_newsletter_brands.pdf.

[45] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 10.

59. Castalia draws on findings from academic papers that suggest high market concentration is associated with high private label penetration. For example, Tarzijan finds that there is a positive relationship between the retailers' concentration and the penetration of private labels.[46]

60. In contrast to the apparent implications of this research, private label penetration is relatively low in New Zealand compared to other countries.[47] Boston Consulting Group and IRI data referred to by Woolworths NZ in its submission to the Commission's preliminary issues paper suggests that private label penetration in New Zealand in 2020 was 15 per cent for edible goods and ten per cent for non-edible goods.[48] Comparatively, in the much less concentrated United Kingdom grocery retail markets, private labels accounted for 52 per cent of edible goods.[49]

61. The low penetration of private label products in New Zealand appears not to be a consequence of the relative lack of private label products. For example, Woolworths NZ notes that it offers more than 3,000 private label products across more than 250 subcategories.[50] Rather, the low penetration of private label products is more likely to reflect New Zealand consumer preferences for branded products.[51]

62. In the context of apparently distinct consumer preferences, it would therefore be disadvantageous for the major grocery retailers to engage in bargaining practices that sought to reduce the availability of branded products. Moreover, the low penetration suggests that major grocery retailers *are not* engaging in practices that substantially discriminate against branded products.

63. Castalia acknowledges that the penetration of private labels in New Zealand is low but suggests that this could increase over time.[52] However, Castalia does not provide any analytical basis for its suggestion that the penetration of private labels in New Zealand are likely to increase, and merely postulates that private label sales 'could' to grow to the levels seen internationally.[53]

64. In contrast to Castalia's suggestion, the prospects for growth in private label penetration is held by others as likely to be slow, with Coriolis Research stating that:[54]

> …the growth of private label in New Zealand has been, and will continue to be, a long and gradual process.

65. Similarly, Nielsen's retail director Lance Dobson was reported to state that the growth of private labels in New Zealand is stagnant, where:[55]

> [t]he penetration of private labels as a percentage of products sold [has] been anywhere between 13.5 and 12 per cent for years.

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[46] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, pp 9-10; and Tarzijan, J, *Private Labels and Retail Market Concentration*, Abante, 2003, 6(1), p 3, available at http://www.abante.cl/files/ABT/Contenidos/Vol-6-N1/1Tarzijan.pdf.

[47] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 288-289, paras 8.140.2 and 8.145.

[48] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 289, para 8.145.

[49] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 289, figure 8.3.

[50] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 288, para 8.142.

[51] See for example, Stuff article, *Budget brands - Kiwis prefer branded groceries over private labels*, 1 April 2016, https://www.stuff.co.nz/business/industries/78418651/budget-brands--kiwis-prefer-branded-groceries-over-private-labels.

[52] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 13.

[53] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector,* August 2021, p 14.

[54] See Coriolis Research website, https://coriolisresearch.com/pdfs/200401_adworks_newsletter_brands.pdf; and Coriolis, Responding to private label, February 2002, p 15, available at: https://coriolisresearch.com/pdfs/coriolis_responding_to_private_label_in_new_zealand.pdf.

[55] Stuff article, *Budget brands - Kiwis prefer branded groceries over private labels*, 1 April 2016, available at https://www.stuff.co.nz/business/industries/78418651/budget-brands--kiwis-prefer-branded-groceries-over-private-labels.

66. Moreover, Coriolis Research reported that private label penetration in New Zealand was almost ten per cent in 2000,[56] with the Boston Consulting Group and IRI data indicating that this has only risen slightly over the last 20 years to 15 per cent for edible goods and 10 per cent for nonedible goods.[57] In contrast to the unexplained suggestion made by Castalia, these estimates suggest that private label penetration in New Zealand is likely to remain low for the foreseeable future, with the private labels continuing to benefit consumers.

67. In our opinion, there is no systematic evidence that private label products are likely to lead to negative outcomes, such as fewer product choices and higher prices, for consumers in New Zealand.

3.3.5 Cost savings likely to be passed on as retailers compete for sales

68. Castalia states that, in the long term, private labels may lead to price increases for consumers because:[58]

> the reduced state of competition in the New Zealand retail market may mean that retailers keep price discounts it [sic] extracts from suppliers.

69. By way of support for this observation, Castalia relies on:[59]

> The Commission's finding that cost savings are not passed through to retail prices.

70. Castalia does not provide any reference by which to verify this contended finding of the Commission, which Castalia expresses in absolute and unqualified terms.

71. Our assumption is that Castalia is referring to the Commission's reporting of analysis it undertook as to the median rate of pass-through of changes in costs for each retail banner. The Commission's analysis found that the median rate of pass-through ranged from:[60]

- 0 to 65 per cent for cost decreases; and
- 8 to 75 per cent for cost increases.

72. In our earlier report,[61] we note that in the main body of its draft report, the Commission expresses the results of this analysis in terms that are less measured than warranted by its empirical analysis, stating that:[62]

> There is limited evidence of retailers passing through cost reductions to consumers.

73. We explain in our earlier report that the Commission does not present any evidence capable of supporting its claim that there appears to be limited pass-through of cost reductions to consumers. Further, we also explain that even if it could be stated with the requisite degree of statistical significance – a claim the Commission does not make – that there was asymmetry in the extent of pass-through of cost changes at a market-wide level, this does not indicate that there is any problem with the intensity or effectiveness of competition.[63]

[56] See Coriolis Research website, https://coriolisresearch.com/pdfs/200401_adworks_newsletter_brands.pdf.

[57] See paragraph 60.

[58] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 13.

[59] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 4.

[60] Commerce Commission, *Market study into the retail grocery sector,* Draft report, July 2021, p 431, para E46.

[61] See HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021, p 25, para 138.

[62] Commerce Commission, *Market study into the retail grocery sector,* Draft report, July 2021, p 287, para 8.138.

[63] See HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021, p 26, paras 147-148.

74. On these considerations, there is no evidence capable of supporting Castalia’s suggestion that cost savings relating to the introduction of private labels may not translate to lower prices for consumers, or worse may lead to higher prices.

75. Where grocery retailers engage in effective competition on price, product range and quality, and level of service, low prices can be expected to be passed onto consumers and the availability of products will be informed by consumer preferences as retailers compete for sales.

76. It follows that there is no basis on which to conclude that private labels will lead to price increases for consumers in New Zealand.

4. No retailer 'conflict of interest'

77. In its closing statement to the grocery market study conference, FCG stated that there is an inherent conflict of interest when retailers provide private labels, saying:[64]

> … in a highly concentrated market like New Zealand's there is harm that arises from the inherent conflict of interest where suppliers deal with their customer who is also a competitor.

78. The Castalia report provides context for the FGC's contention as to grocery retailers' conflict of interest, stating:[65]

> Retailers are both a customer and competitor of named brands when they market their own private labels. When retailers have market power (such as in a concentrated market), the retailer may be incentivised to discriminate in favour of its private label. This is because the retailer's margins from private labels increase in conditions of poor retail competition.

79. In our opinion, the proposition that grocery retailers have a conflict of interest because they are both a customer and competitor of their suppliers does not accurately reflect the economic function performed by grocery retailers' in relation to private labels. For example, Castalia explains that:[66]

> Retailers typically contract a third party to produce the private label product.

80. Regardless of the level of market concentration and intensity of competition, grocery retailers have an incentive to provide consumers with the optimal mix of products and prices, to increase their sales and thereby maximise profits. Retailers' procurement decisions are dependent on consumer preferences and supply costs, a process that generates competition between suppliers of both branded and private label products to offer products that are highly demanded at a low price.

81. Grocery retailers procure private label products from third party suppliers; they do not 'produce' goods themselves. By this delineation, suppliers of branded goods are in competition with suppliers of private label goods, rather than grocery retailers.

82. In our opinion, the suggestion that grocery retailers that offer private label products are competing directly with their suppliers, thereby resulting in a conflict of interest, misunderstands the respective economic functions performed by retailer and supplier, irrespective of whether the latter is supplying private label or branded products.

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[64] Commerce Commission, Day 7 - Retail grocery market study conference, Transcript p 29, lines 36-38.

[65] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 9.

[66] Castalia, *Private labels, buyer power and remedies in the NZ grocery sector*, August 2021, p 6.

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