

Market study into the retail grocery sector

Draft report – Executive summary



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Overview

This report sets out our preliminary findings from our study into New Zealand's retail grocery sector. The purpose of the study is to examine whether competition in the grocery sector is working well and, if not, what can be done to improve it.

Groceries are an essential purchase for all consumers as well as a major expense for most households. In the year to December 2020, more than \$22 billion was spent at supermarkets and grocery stores. In the year to June 2019, food was the second largest expense for New Zealand households, with an average spend of \$234 a week.

The high level of concentration in the sector, potential competition concerns and the prices consumers pay for their groceries were reasons cited by the Minister of Commerce and Consumer Affairs for asking us to undertake this study.

Our study is focused on understanding competition in the grocery sector and does not look at other factors which may be affecting grocery prices such as tax, freight and labour costs, inflation, or seasonality.

If competition is working well for consumers in the long term, we would expect to see grocery retailers competing to deliver consumers the range and quality of products at the right price to satisfy their preferences. In a competitive market, businesses are also incentivised to innovate and there is ongoing pressure on firms to attract and retain consumers. These dynamics mean that firms' profits are limited over time.

Our study focuses on the retail supply of groceries to New Zealand consumers. This includes meat, fruit and vegetables, canned goods, dairy products, and a range of other household products, like toilet paper, cleaning products and pet food. Our study also includes alcohol and tobacco where these are sold by grocery retailers.

We have not analysed the grocery sector's immediate response to COVID-19 or its short-term effects on competition. However, we have considered whether any issues or practices that have emerged during the pandemic are likely to affect competition in the longer term.

The retail grocery sector is diverse and made up of a range of retailers catering to the needs of a similarly diverse range of consumers through a mix of supermarkets, specialist and international food stores, convenience stores, online-only supermarkets and meal kit providers.



Prominent in the sector are two major operators of nationwide supermarket chains: Woolworths New Zealand Limited (Woolworths NZ) and Foodstuffs. These supermarket chains are a significant focus for our study. Throughout this report, we refer to them as ‘major grocery retailers’ and to those grocery retailers that are not part of these groups as ‘other grocery retailers’.

Consumers engage in a range of different shopping missions, including:

- a main shop typically at weekly, or at another regular interval, based on the convenience of using one grocery store to get all necessities in one place
- a secondary shop for specific products, typically at a specialist retailer, and/or
- a top-up shop for a small number of items, often across a range of other grocery retailers.

While New Zealanders have a diverse range of preferences for why, where and how they shop, a significant proportion of consumers prefer to buy groceries during a main shop in one location at one of the major grocery retailers’ supermarkets. Therefore, other grocery retailers are more likely to be regarded by consumers as an alternative for ‘top-up’ or smaller shopping trips.

Woolworths NZ operates and supplies more than 180 Countdown stores throughout New Zealand. Woolworths NZ also owns Wholesale Distributors Limited, which is the franchisor to 71 locally-owned and operated SuperValue and Fresh Choice stores, which mainly operate in smaller centres.

Foodstuffs operates as two separate cooperatives: Foodstuffs North Island (Foodstuffs NI) and Foodstuffs South Island (Foodstuffs SI). There are more than 400 Foodstuffs retail stores nationwide operating under the New World, PAK’nSAVE and Four Square banners, as well as Raeward Fresh and On the Spot stores in the South Island.

The major grocery retailers are also wholesalers, but largely only supply themselves. They own and operate central distribution centres which supply their retail stores throughout the country. There are some other independent wholesalers which supply retailers with some product categories like fresh produce, meat, and international products. The breadth of wholesale supply options available to the other grocery retailers affects the extent to which they can compete with the major grocery retailers for a consumer’s main shop.

The wholesale purchasing of groceries by retailers from growers and other food and grocery producers has also been a significant focus for our study. The major grocery retailers’ supermarkets are a critical route to market for many suppliers. Further, consumers benefit from better products when suppliers have the ability and incentive to invest and innovate.

Key findings

Our preliminary finding is that competition is not working well for consumers in the retail grocery sector. If competition was more effective, retailers would face stronger pressures to deliver the right prices, quality and range to satisfy a diverse range of consumer preferences.

In reaching our preliminary finding we have identified a range of market outcomes that we consider are inconsistent with what we would expect to see in a workably competitive market including prices, innovation and profitability. We have then analysed aspects of competition that we consider may be contributing to these outcomes. They are the structure of the grocery retailing industry, the conditions for entry and expansion by potential rivals, consumer preferences and the way retailers compete for and interact with consumers, and issues associated with retailers’ wholesale purchasing of groceries from suppliers.

Price, profits and innovation

We have observed consistently high profits being earned by the major grocery retailers. If competition was working better, we would expect these profits to attract new entry and expansion by other grocery retailers, bringing profitability back to a more competitive, or 'normal', level.

While it is difficult to compare grocery prices internationally, it appears that New Zealand prices are relatively high by international standards.

It also appears that while there has been innovation in the sector, it is modest by international standards. High profits do not appear to be rewarding retailers who have invested in innovation, as slow adopters also appear to enjoy them.

Market duopoly and high barriers to entry

The retail grocery sector can best be described as a duopoly with a fringe of other competitors. While there are a number of different retail banners in New Zealand, the grocery market is dominated by Foodstuffs and Woolworths NZ's supermarket chains.

The fringe of other competitors is made up of a range of retailers that provide options for some consumers. However, they have a limited impact on the major grocery retailers. An important reason for this is that most consumers regularly carry out a main shop from one supermarket and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.

Competition tends to be weak in a duopoly, unless it is easy for rivals to enter and/or expand to a scale to directly compete with the duopolists. This does not appear to be the case for a number of reasons. We consider two are particularly important. First, there is a lack of competitively priced wholesale supply for a full range of grocery products. Second, there is a lack of suitable sites for store development. This is aggravated by the major grocery retailers lodging restrictive covenants on land and including exclusivity covenants in leases to prevent their rivals from opening stores.

While there have been a number of smaller scale new entrants, the emergence of meal kit providers and the upcoming entry of Costco to Auckland, it is unlikely under current market conditions that any new grocery retailer with a similar retail offer to the major grocery retailers will enter at the scale required to compete with them for a consumer's main shop.

We have also found that Foodstuffs and Woolworths NZ choose strategies that limit competing directly with each other, particularly on price. For example, each supermarket banner targets a different section of the consumer population.

Other grocery retailers are largely unable to compete on price and offer the full product range to satisfy the consumer preference for one-stop shopping. This allows the major grocery retailers to operate without fear of losing too many consumers to other retailers, even in the main urban areas. Rural consumers typically have even more limited options.

Issues facing consumers

Consumers are confident and more inclined to shop around when they can compare product offerings both within store and between retailers and can gauge an accurate perception of value to help them to choose where they would like to shop. This in turn incentivises retailers to compete to meet consumers' needs such as through offering new products and services or reducing prices.

We consider that the frequency and prevalence of the major grocery retailers' pricing and promotional practices, and the complexity of the reward structures and terms and conditions relating to their loyalty programmes can confuse consumers. This makes it more difficult for consumers to compare prices and make informed purchasing decisions, and reduces the effectiveness of price competition between the major grocery retailers.

We also find that consumers are generally not aware of how their data is being collected and used when they sign up for loyalty programmes. Therefore, consumers with strong data-use preferences may not make fully informed choices about whether to participate in loyalty programmes, affecting competition for those consumers between the major grocery retailers.

Issues facing suppliers

We have also observed that competition for the wholesale purchasing of groceries is not working well for many suppliers.

Many suppliers have few options and are reliant on the major grocery retailers to sell their products. With only two major grocery retailers, which between them have a high estimated market share, in many instances there is limited competition for the purchase of suppliers' products. This can create an imbalance of bargaining power and the major grocery retailers can use their buyer power to shift costs and risks onto suppliers, insist upon uncertain terms of supply, and limit suppliers' dealings with other grocery retailers. This includes the threat of delisting their products from supermarket shelves if a supplier does not agree with the major grocery retailer, for example, on contract terms, margins or pricing.

This can reduce suppliers' incentives to invest and innovate, ultimately leading to lower quality goods and reduced choice being available to consumers. There is also the risk that prices will rise in the long run if suppliers exit the market.



Options for Recommendations

We have developed a spectrum of options for recommendations to improve competition based on our preliminary findings.

We consider that the best options for improving competition are likely to be those that enable an increase in the number of grocery retailers that compete directly with the major grocery retailers. In the long term, threatened and actual entry or expansion is likely to be the greatest driver of competition.

The first way an increase in competition directly with the major grocery retailers could occur is through measures to improve the conditions for entry and expansion by rivals. These include measures to improve access to a wide range of wholesale groceries at competitive prices, and measures to make more sites available for grocery retailing.

The second way this could occur is through measures to facilitate or create entry by further major grocery retailers. These include direct sponsorship of entry by government either by encouraging investment, by direct entry, or by requiring the major grocery retailers to sell some of their stores to create additional major grocery retailers.

We consider that the power imbalance between the major grocery retailers and their suppliers could be addressed through a number of measures, including a mandatory code of conduct and changes to allow collective bargaining by suppliers.

Finally, there are some measures directed at improving the information provided to consumers to help them make more informed purchasing decisions and to enhance competition at the retail level of the market. These include the introduction of mandatory unit pricing, and the major grocery retailers simplifying their promotional practices and ensuring that the terms and conditions of their loyalty programmes are clear and transparent.

Other matters of interest to the Commission

Some information we have collected that is relevant to the question of whether competition is working effectively also could indicate conduct that merits further consideration under the Fair Trading Act or other parts of the Commerce Act prohibiting anti-competitive conduct. Independent of this study, we are considering what further action may be required utilising our compliance and enforcement functions and powers in relation to those matters.

Summary of our analysis

Our analysis for this study began by examining market outcomes or indicators of competition that can be compared with benchmarks from competitive markets. In particular, we have looked at the profitability of major grocery retailers, international price comparisons and levels of innovation and investment in the retail grocery sector.

Profitability

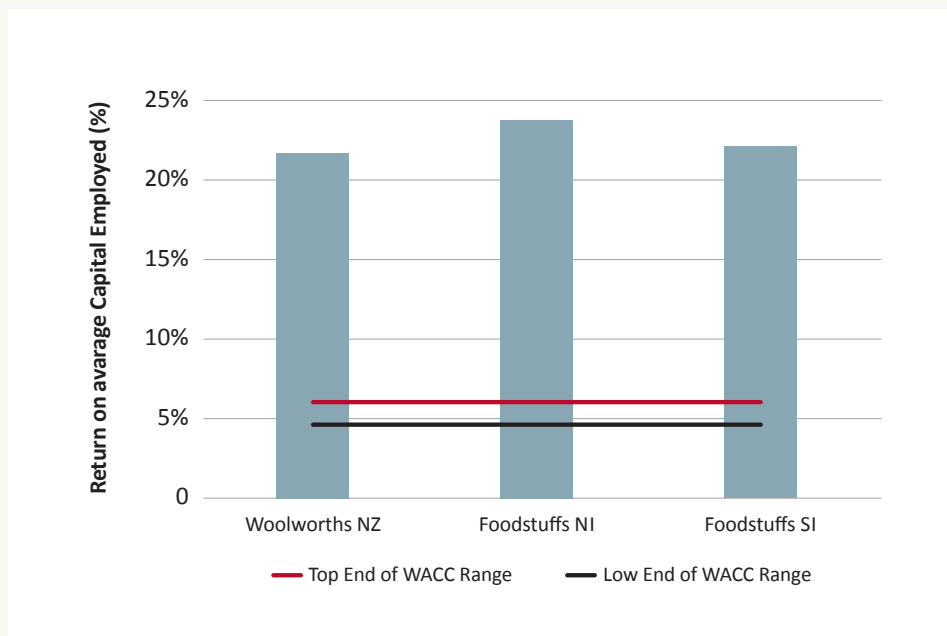
We have observed that the level of profits being earned by the major grocery retailers are consistently and materially above what we would expect in a workably competitive market. This level of profitability has been observed using a variety of profitability measures.

Major grocery retailers are earning excess levels of ROACE

The Return on Average Capital Employed (ROACE) profitability measure determines what the retailers earned historically based on the value of the assets they have used to generate those earnings. This level of profitability is compared against their Weighted Average Cost of Capital (WACC), which is the benchmark that represents a normal (risk adjusted) rate of return.

Our analysis shows the estimated average ROACE for the major grocery retailers between 2015-2019 is between 21.6% and 23.8%. This is in excess of our estimate of WACC for these companies, which is between 4.6% and 6.1%.

Average ROACE for the major grocery retailers compared to WACC (2015-2019)



We have made various adjustments to account for the unique features and business models of the major grocery retailers in compiling these estimates. We also tested their sensitivity to alternative assumptions. In all cases, the levels of ROACE for these companies were materially above our WACC estimate.

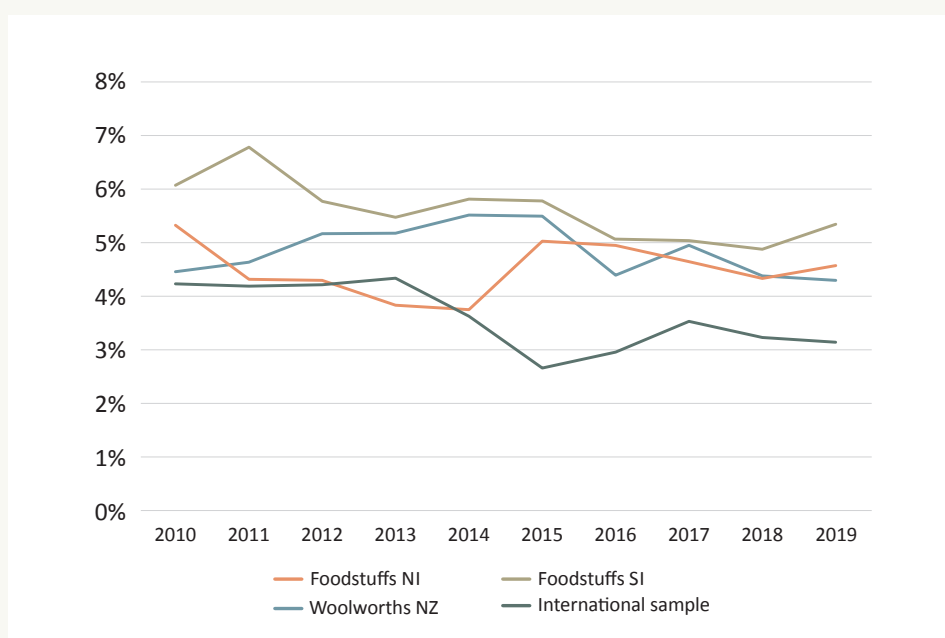
Business cases show high expected rates of return

We examined the levels of profit that the major grocery retailers expect to make on new investments. The profit expectations for the 35 business cases we examined were typically between 15% and 25% per annum which materially exceeds our estimated WACC range for all years in the period from 2015 to 2020. These profit expectations also appear to have been achieved once the investment had been made.

Profit margins have been consistent over time and above international comparators

We also compared the major grocery retailers' levels of profitability to that of international retailers. Provided below is the EBIT (earnings before interest and tax) margin for the major grocery retailers from 2010 to 2019 compared to a sample of international grocery retailers. As shown, their level of EBIT relative to their sales is materially above the international sample.

EBIT profit margin for the major grocery retailers relative to international grocery retailers (2010-2019)



International price comparisons

Consumers told us that they consider grocery prices in New Zealand to be high and that they are higher than those they have experienced overseas.

While it is difficult to compare grocery prices internationally, a range of data appears to show that New Zealand ranks in the top 10 most expensive grocery markets out of all 38 OECD countries.

Of the two datasets we consider to be the most reliable, the OECD and International Comparisons Program (ICP) datasets indicate that New Zealand was the sixth most expensive grocery market in the OECD in 2017.

New Zealand also ranked highly in the OECD in terms of the amount spent on groceries. In the three datasets we analysed, New Zealand ranked at least the sixth highest spend per capita on grocery products in the OECD in 2017.

Innovation and investment

Our preliminary view is that while there has been some innovation in the sector directed at product and service differentiation, it appears modest by international standards. Further, high profits do not appear to represent rewards for investing in innovation as they are also being enjoyed by slow adopters.

Online retailing

COVID-19 has contributed to increased demand for online grocery retailing. However, online grocery sales growth and penetration is still comparatively low by international standards and the rate of digital innovation by some retailers appears to be lagging behind other countries.

For example, Foodstuffs SI's New World and PAK'nSAVE banners have only recently started rolling out online offerings.

In-store innovations

In the 'bricks and mortar' offering, examples of investments to improve product and service offerings by the major grocery retailers include more self-checkouts, Scan&Go technology, smaller and more premium 'metro' stores, in-store pharmacies, and a more diverse product range.

However, the pace and scale of innovation to improve the in-store experience in New Zealand also appears to be slower than in other countries. Examples of overseas innovations include the use of mobile apps in-store for online price comparison purposes, drive-through grocery collection, and the growing use of grocery robots.

Innovations targeted at efficiency

In recent years, the major grocery retailers have invested in central distribution centres and online-only supermarkets. Improved supply chain efficiencies have reduced operating costs for the major grocery retailers, but it does not appear that these reduced costs are being passed on to consumers in the form of lower prices.



Consumer preferences when shopping for groceries

Our preliminary findings on consumer preferences in the retail grocery sector were informed by submissions, information from grocery retailers, a consumer survey involving more than 12,000 New Zealanders, qualitative research (including focus groups) conducted by Ipsos and experimental research into consumer decision making under complexity undertaken by behavioural economists at the New Zealand Institute for Business Research at the University of Waikato's Experimental Economics Laboratory (WEEL).

New Zealanders have a diverse range of preferences for why, where and how they shop, but some common themes emerged from our research.

Many consumers prefer to buy their groceries at a 'one-stop shop'

Our preliminary finding is that a significant proportion of consumers prefer to buy groceries during a main shop in one of the major grocery retailers' stores.

While consumers choose where to shop based on a range of factors which can vary by type of shopping mission, convenience and price are key drivers of store choice, and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.

Consumers tend to use other grocery retailers mostly for smaller, secondary or top-up shopping missions, though major grocery retailers are also an attractive option for these missions.

This means that other grocery retailers who have a more limited or targeted range of products and fewer stores are not a serious competitive constraint on the major grocery retailers. This is consistent with national market share estimates showing that the major grocery retailers have a combined market share of more than 90% for consumers' main shop, and more than 80% for top-up shops. We expand on this below in our discussion of competition in the retail market.

Consumers typically travel short distances to buy groceries

Competition for specific shopping missions mostly occurs in local markets due to the limited distances consumers are generally willing to travel to buy groceries.

Analysis of our consumer research shows that on average consumers in major towns and cities travel less than 10 minutes to their main store. Meanwhile, consumers located in small urban and rural areas tend to travel longer to their main store, with consumers in rural areas travelling closer to 20 minutes on average. The approximate geographic size of local markets may vary between different types of shopping missions and grocery stores. For example, consumers may be willing to travel further for their main shop or to shop at bigger supermarkets.

There are regional differences in grocery retail options available

Our analysis shows that consumers have different shopping options available to them depending where they live. The greatest level of diversity appears to be in the Auckland region, where there are many other retailers operating in addition to the major grocery retailers, such as Farro Fresh, a wide range of international food stores and specialist retailers like The Mad Butcher and Fruit World. There are lower levels of diversity throughout the rest of the country, with the lowest level of diversity evident in rural areas. There are some regional price differences for groceries throughout New Zealand. For instance, prices in the South Island and the central and lower North Island are higher relative to those in Auckland.

Competition at the retail level

We have looked at the structure of the retail grocery sector and the intensity of competition between retailers.

Our preliminary finding is that while there are a number of different retailers operating, the sector is dominated by the major grocery retailers and they appear to be each other's closest competitors. We have seen no evidence to suggest that other grocery retailers constrain the major grocery retailers to a significant extent for a consumer's main shop in any local market(s), either individually or together.

In competition terms, we refer to this as a duopoly with a fringe of other competitors. We have found that the major grocery retailers choose strategies that limit the extent to which their retail banners compete directly with each other, particularly on price. For example, we have seen evidence that the major grocery retailers actively monitor one another's price levels for specific products with the aim of managing specified pricing differences between their retail banners.

The major grocery retailers' market shares for groceries are also very stable over time, suggesting weak competition between them but also between them and other grocery retailers.

Competition with the fringe of competing retailers

The fringe of other grocery retailers provides consumers with choice and helps meet diverse consumer preferences. However, other grocery retailers cannot match the major grocery retailers' cost and scale advantages and cannot compete with the major grocery retailers on price or range for a consumer's main shop.

Instead, it appears these retailers strategically compete for smaller consumer shopping missions by differentiating the non-price components of their retail offers such as stocking different, imported or higher quality products, or creating unique shopping experiences.

Product and service differentiation provide a way for grocery retailers to avoid directly competing on price, while seeking to attract consumers from one another in an effort to attract and retain a more loyal consumer base.

Many consumers told us that lower prices are the most important thing for them. Price competition is an important feature of a workably competitive market.

Meal kit providers provide an additional convenience option for consumers

Meal kit providers such as My Food Bag and HelloFresh have grown significantly in recent years. The major grocery retailers consider that they compete with them by reducing the size of a consumer's main shop. In response, the major grocery retailers have expanded their ready-to-eat and quick-to-prepare offerings.

While there may be a degree of competition between meal kit providers and the major grocery retailers for consumers that value convenience, meal kits do not remove the need for consumers to buy pantry staples and do not typically cater to all meals. Although meal kit providers have grown significantly in recent years, their combined share of the total grocery retail market remains small. Our preliminary view is that meal kit providers form part of the fringe of other grocery retailers. They compete on range and service but do not provide price competition for the major grocery retailers.

To what extent does the fringe of other grocery retailers compete with the major grocery retailers?

The major grocery retailers told us that they face high levels of competition from other grocery retailers. However, our preliminary view is that the major grocery retailers are each other's closest competitors and are not constrained by other grocery retailers, either individually or collectively.

For example:

- the major grocery retailers regularly monitor each other's prices for a core range of products and adjust their retail offers in response to changes. In comparison, this is done on an ad hoc basis (at best) for other retailers
- when benchmarking store performance and prices and discussing ways in which to adjust or improve their respective retail offerings, the major grocery retailers mostly only have regard to each other's retail offerings
- the major grocery retailers' business cases for new stores generally only assess competition by existing major banners within the relevant catchment area.

Work undertaken by Frontier Economics for our study supports our preliminary finding of a duopoly with a fringe of other competitors. It suggests that the major grocery retailers' prices appear largely unaffected by having more grocery retailers located in close proximity to their supermarkets regardless of whether the nearby retailers are major grocery retailers or a combination of major grocery retailers and other grocery retailers.

How intense is the level of competition between the major grocery retailers?

Given the lack of competition between the major grocery retailers and other grocery retailers, the strength of competition between Foodstuffs and Woolworths NZ is a key driver of the prices, quality and range of grocery products available to consumers.

As noted above, much of the evidence supporting our preliminary view that the major grocery retailers are not constrained by other grocery retailers also indicates that they are each other's closest competitors. However, the market outcomes we have discussed relating to profits, price, innovation, and market shares also support our preliminary view that price competition between major grocery retailers is weak. In addition, the major grocery retailers actively choose and monitor strategies that limit the extent to which their retail banners compete directly with each other, particularly on price. For example, PAK'nSAVE aims to be the cheapest, New World offers a wide range and premium service, and Countdown pitches itself in between. This appears to be done mainly with the aim of attracting a more loyal and exclusive customer base.

This differentiation and the persistently high profits and stable market shares for the major grocery retailers indicate that competition between the major grocery retailer banners is less than we would expect in a workably competitive market.

Conditions of entry and expansion

There has been no large-scale entry into the New Zealand retail grocery sector since The Warehouse Group's attempt in 2006. We note in recent years there has been a number of smaller scale or niche entrants into the market, such as online-only retailers Supie and The Honest Grocer and the emergence of meal kit providers. We are also aware of the planned entry of member subscription retailer Costco, which is due to open an Auckland store in August 2022.

While these new entrants have improved and may further improve choice to consumers, at this stage we do not consider that under current market conditions, they will significantly improve competition except for niche groups of consumers or types of shopping mission.

We acknowledge that large-scale entry may be made difficult by New Zealand's size and population profile. This may restrict the number of places a new supermarket can be profitably operated. There may also be limited land available in the areas where expansion is viable, such as in Auckland. The major grocery retailers' large store and distribution networks also give them access to economies of scale and the ability to negotiate volume discounts through bulk buying.

However, aside from these factors, we have identified several of other significant barriers to entry and expansion.

Lack of wholesale grocery supply on competitive terms

Our preliminary finding is that the absence of wholesale grocery supply on competitive terms is a key factor preventing entry and expansion in the retail grocery sector.

The major grocery retailers are also wholesalers but largely only supply themselves, distributing products to stores operating under their banners throughout New Zealand. Suppliers either deliver products to their distribution centres or direct to stores. The Foodstuffs groups also contain two wholesalers. Trents is owned by Foodstuffs SI and Gilmours store owners are part of the Foodstuffs NI group. Although their businesses focus on foodservice, they also supply some convenience stores and other grocery retailers.

The lack of independent wholesale options for a full range of groceries is currently preventing other grocery retailers from competing with the major grocery retailers for the consumer-favoured main shop.

Any large-scale entrant into grocery retailing, whether a general merchandiser or a new entrant, must source products separately from a large number of individual suppliers and organise related logistics, including for temperature-controlled goods.

Others, such as convenience stores and dairies, frequently find that their best option is to buy groceries from supermarkets for resale.



Constraints on site availability

The availability of land for grocery store development is aggravated by the major grocery retailers placing restrictive covenants on land and exclusivity covenants in leases that prevent rival supermarkets from developing stores. These practices weaken competition between the major grocery retailers and insulate them against competition from a large-scale entrant.

For example, we have identified more than 80 covenants entered into by the major grocery retailers restricting a competitor's food or retail grocery store development. At least 50 of these are not time limited or have a term of more than 20 years. We have also identified more than 120 instances of exclusivity covenants being used in lease contracts restricting the development of nearby food or grocery retail, a majority of which are still active, with more than 100 instances having a term of more than 20 years (taking into account the right of renewal). Our preliminary view is that these restrictions are likely to be a significant factor inhibiting entry by a rival grocery retailer seeking to establish a network of stores by preventing or slowing entry and expansion on otherwise suitable sites.

Planning laws and their implementation by territorial local authorities can also affect the potential for competition in the grocery sector if the potential benefits of competition are not consistently taken into account when considering planning matters.

Purchasing and holding land without using it, or landbanking, can also reduce the availability of sites for use by competitors but we do not consider this practice currently constrains competition on its own.

Issues facing consumers

Our preliminary finding is that the frequency and prevalence of promotional mechanisms used by the major grocery retailers, and the complexity of the reward structures and terms and conditions relating to their loyalty programmes, can confuse consumers. This may make it more difficult for consumers to compare prices and make informed purchasing decisions, and may reduce the effectiveness of price competition between the major grocery retailers.

The use of multiple promotional mechanisms and how they are framed distorts consumer decision making and lessens competition

Promotions can provide value to consumers and drive competition between the major grocery retailers. However, if it is difficult for consumers to compare offers, they may make less informed purchasing decisions which can reduce price competition and harm consumers directly.

The major grocery retailers use an array of different promotional mechanisms. They include short-term specials, multi-buys providing a discount when a specified number of items is purchased, discounts provided only for members of loyalty programmes, and a pricing strategy based on offering a 'low' price for an extended period.

The WEEL report tested whether the display of multiple and/or complex promotional pricing mechanisms affects consumer decision making when faced with complexity of pricing and promotional offers. It broadly found that the greater number of offers and the more complex the offers consumers are provided with, the less likely they are to make purchasing decisions that best meet their needs.

The way promotions are framed adds complexity to consumer comparisons of products and can divert consumer attention away from the price paid to the discount received. Our preliminary finding is that the major grocery retailers' use of an array of different promotional mechanisms, their complexity and frequent use, particularly in combination with one another, makes it hard for consumers to accurately assess the value of competing offers and develop accurate perceptions of value over time. This is the case even when there are genuine savings on offer and the information provided is clear.

This means consumers may be making less-informed purchasing decisions, which may affect price competition between grocery retailers in the longer term. It also harms consumers directly if they are not making purchasing decisions that best meet their needs.

While the major grocery retailers use unit pricing in relation to some products they offer, it is not consistently used or displayed. This limits the assistance that it gives consumers in comparing prices or developing a perception over time of the value offered by their chosen grocery retailer. Additionally, displaying unit pricing may help to reduce complexity arising from the use of multiple promotional pricing mechanisms.

Loyalty programme membership is popular

New World and Countdown have well established loyalty programmes that offer member-only discounts, accumulated rewards, some personalised offers, as well as the ability to earn and redeem points with partners (eg, AA Smartfuel, Flybuys, and Airpoints).

Consumer uptake of these loyalty programmes is high. A 2020 review of loyalty programmes by Consumer NZ found that Countdown's Onecard programme had two million members while New World's Clubcard had 1.6 million. Consumers are often members of multiple loyalty programmes, with access to member-only discounts generally cited as the most common reason for signing up.

Consumer understanding of loyalty programmes is low and this can affect competition

Loyalty programmes can intensify competition and provide consumer benefits through discounts and rewards.

However, despite their popularity, our preliminary finding is that consumer understanding of loyalty programmes is low. This is particularly in relation to how accumulated rewards are earned and redeemed and how consumer data is collected and used by the major grocery retailers.

Many consumers reported using loyalty programmes to access immediate member-only discounts when they shop at the supermarket. Others also value accumulated benefits but our preliminary finding is that they may not clearly understand how these rewards can be earned. For instance, a consumer needs to spend \$2,000 at Countdown within a year to receive a \$15 voucher, a value of 0.75% of the spend needed to earn the voucher. The points-based reward structure at New World is more complex but represents a similar value.

Our preliminary finding is that the complexity of rewards structures can make it difficult for consumers to understand how discounts and rewards are earned, and to compare them with those offered through other loyalty promotions and other promotions. Like confusion arising from promotional mechanisms, this can reduce a consumer's ability to compare prices and reduce price competition between the major retailers.

In addition, the major grocery retailers collect large amounts of data from members of their loyalty programmes. Our preliminary view is that consumers are generally not aware of how their data is being collected and used when they sign up for loyalty programmes. For example, loyalty memberships can be linked to payment cards and consumer data can be provided to third parties. These practices are not made clear to consumers. Therefore, consumers with strong data use preferences may not be able to make fully informed choices about whether to participate in loyalty programmes, affecting competition for those consumers between major grocery retailers.

Loyalty programmes can also affect some consumers' willingness to shop around

Loyalty programmes can also shift focus for some consumers away from retail prices and toward earning accumulated rewards. While our preliminary view is that this is insufficient at present to create a barrier to entry or expansion by grocery retail competitors, those consumers may be less inclined to shop around.



Issues facing suppliers

Suppliers such as farmers, growers, manufacturers and processors of grocery products play a critical role in the grocery sector. Our preliminary view is that competition for the wholesale purchasing of groceries is not working well for many suppliers.

Our analysis of this topic has benefited from survey information, interviews and submissions from suppliers and the organisations representing them, and from some information supplied by the major grocery retailers.

The feedback we have received has been mixed. We have heard some positive feedback about retailers. For example, suppliers referred to retailers providing product exposure by supporting promotions or displays, stocking new products, and supporting innovative ideas. Suppliers also generally speak positively about their trading relationships with other grocery retailers like Farro Fresh, Commonsense Organics, and Moore Wilson's.

However, many suppliers described negative experiences in similar ways and we consider these may indicate that competition is not working well. The feedback we received varies by different retail banners and sometimes individual stores. We acknowledge that retailers' strategies change over time and certain companies may be the focus of supplier complaints at any given time. For example, Foodstuffs NI is currently implementing a new centralised buying model, which has raised concerns for many suppliers.

We have focused our discussion on some key themes regarding interactions between retailers and suppliers, rather than focusing on specific examples of conduct by particular retailers and we have not considered the circumstances or potential commercial rationales for each party underlying the kinds of interactions described to us.

Many suppliers have few options and are reliant on the major grocery retailers to sell their products. This can create an imbalance of bargaining power and the major grocery retailers can use their buyer power to shift costs and risks onto suppliers, insist upon uncertain terms of supply, and limit suppliers' dealings with other grocery retailers. This can reduce suppliers' incentives to invest and innovate, ultimately leading to lower quality goods and reduced choice being available to consumers.

Transferring costs and risks from retailers to suppliers

All commercial contracts involve an allocation of risk, and in well-functioning markets risk tends to be allocated to the party best able to manage it. However, we have heard that this often may not happen in the wholesale purchasing of groceries by major retailers. Examples include suppliers bearing costs and risks of:

- retail promotional discounts (including retailers stockpiling products bought in expectation of a promotion)
- merchandising (including the costs of stocking products on shelves and preparing product displays)
- damaged, unsaleable, lost and stolen stock that occurred while the retailer was in possession of the products
- standard invoice settlement terms which allow extended payment terms for retailers, with some suppliers waiting up to 60 days for payment.



Reduced transparency and certainty over terms of supply

In well-functioning markets, we would expect terms of supply to establish clear and transparent rights and obligations. However, we have heard examples of retailers:

- not providing notice or clear justification for delisting products from their shelves
- taking a long time to respond to supplier requests for price increases
- deducting amounts against supplier's invoices without prior consent
- not committing to provide suppliers with promotional displays.

Limiting suppliers' ability or incentive to provide favourable supply terms with other retailers

We are aware of several examples of retailers allegedly limiting the ability of suppliers to deal with other retailers. For example, by applying pressure for suppliers to not supply competing grocery retailers due to low retail pricing.

Suppliers who encounter difficulties when trading with grocery retailers also appear to have limited ability to resolve disputes. While the major grocery retailers have supplier charters, our current understanding is that relatively few complaints are made. Given the concerns we have heard, it appears that suppliers may be reluctant to raise complaints or enforce their rights due to fear of retribution, such as delisting products or reducing the range stocked by the major grocery retailer.

Private label products

Private label products can benefit consumers through lower prices and greater choice. They can promote competition, facilitate entry or expansion by suppliers producing volumes of private label products. However, there is also a risk that private label products can crowd out supplier branded products and reduce options and raise prices for consumers over the longer term.

Private label product sales are slowly growing in New Zealand, but are still relatively low when compared with other countries. We have identified some ways in which the use of private label products could potentially harm competition. These include retailers discriminating between private label and supplier branded products, for example, when allocating shelf space and infringing upon suppliers' intellectual property and reducing innovation. Our preliminary view is that at this stage it is not clear whether the overall longer-term risks associated with private label products outweigh any potential benefits to consumers in the short term.

Options for recommendations

Our preliminary view is that retail grocery competition is not what we would expect in a workably competitive market. We have seen no evidence to suggest that there is any prospect of increased competition emerging under current conditions without some form of intervention.

We consider the best way to improve retail grocery competition is through measures that enable an increase in the number of firms competing effectively in grocery retail markets. This is particularly in relation to those competing for a consumer's main shop. Our preliminary view is that the New Zealand market is not too small to accommodate at least one more large scale rival.

We have identified a spectrum of options for recommendations that identify different possible ways to improve competition and produce better long-term market outcomes for consumers. These are the options for which we consider further investigation may be warranted. We acknowledge the importance of assessing whether the benefits exceed the costs or any recommended changes to the status quo.

We invite comment on the options we have identified and any others that could improve competition. Like the preliminary views expressed in our report, the options are subject to further consultation and may be altered or removed in our final report.

Increasing wholesale access to a wide range of groceries at competitive prices

We consider that a necessary first step to support any current or future competitor to the major grocery retailers is to increase wholesale access to a wide range of groceries at competitive prices.

Achieving this outcome could result in entry by firms who are not currently involved in grocery markets such as those in complementary retail businesses who could move into grocery retail, or an entirely new major grocery retailer. It could also result in the growth and expansion of existing grocery retailers such as independent grocery retailers and one or more online-only supermarkets.

There are several options to achieve this:

- The existing major grocery retailers could undertake to supply other retailers with groceries on fair and non-discriminatory terms. Each of the major grocery retailers appear to already have some of the systems in place to provide wholesale grocery supply, either through subsidiaries or directly.
- A regulated access regime could be established with the aim of achieving the same outcomes. We do not envisage that such a regime would involve price regulation, but rather that access would be provided on non-discriminatory terms. Operational separation inside the existing major grocery retailers may or may not be necessary to support this approach. Operational separation would require each of them to operate their wholesale and retail businesses separately and independently from one another within the same organisation.
- The facilitation or sponsorship of a new independent wholesaler through a competitive tender process. This would give grocery suppliers a third significant wholesale channel.
- In the event that none of the above options were viable, a possible last resort option is to vertically separate the two major grocery retailers by requiring the major grocery retailers to structurally separate their wholesale business from their retail business by moving the businesses into entirely separate companies. A separate wholesale or retail business could also be sold to an independent third party.

Free up sites for retail supermarkets

We consider that freeing up sites for supermarkets is also critical to facilitating more effective competition among grocery retailers.

We encourage the major grocery retailers to consider whether there is a pro-competitive justification for the imposition of restrictive covenants and exclusivity covenants in future, and to avoid them where they may impact competition and release any existing covenants where this is possible. We also discuss other regulatory intervention and/or amendment to the Commerce Act that may be required to assist with releasing, and reducing the use of, these instruments.

We have also outlined ways in which the proposed Natural and Built Environments Act that is currently under development could include the benefits of competition as part of the new planning framework.



Directly stimulate retail competition

The above options for recommendations rely upon effective competition with the major grocery retailers emerging if the conditions for entry and expansion are improved. In reality, this outcome is uncertain. For example, even if subsequent analysis shows that a new independent grocery wholesaler is the preferred way of increasing wholesale access to a wide range of grocery products at competitive prices, it may not be commercially feasible for such a firm to enter without a retail network of matching scale providing the demand for its products.

Accordingly, to ensure we are consulting on a full range of options, we also have identified two options for recommendations to directly stimulate retail competition. Both of these options are aimed at the retail market directly and would also require increasing access to wholesale supply and the freeing-up of potential retail sites.

- One option is the facilitation or sponsorship of retail entry following a competitive tender process. This could be short or longer term support, investment as a joint venture partner and/or with a view to exit when competition is established.
- The second option is requiring the major grocery retailers to sell some of their stores to create a third viable major grocery retailer.

The costs and risks of these options would be significant. We therefore anticipate that these measures are only likely to be appropriate if the costs, risks and expected benefits had been considered, and other options, particularly in relation to the wholesale market, were not feasible, had proved ineffective, or did not appear likely to improve competition within the desired timeframe.

Supplier Code of Conduct

We consider that it would be beneficial to introduce a mandatory Code of Conduct to help strengthen suppliers' bargaining power with retailers and prevent current conduct which reduces the ability and incentive of suppliers to invest and innovate. An effective Code of Conduct may need to be determined by Government, rather than industry self-regulation.

Our options for recommendations also include a recommendation for a general code-making power built into the Commerce Act which may produce more consistent and predictable codes over time in different sectors with similar needs.

There are grocery codes available from the UK and from Australia which we consider may be useful guides to the development of a Code of Conduct in New Zealand.

We also recommend consideration of methods to authorise collective bargaining by suppliers in relation to supply contracts entered into with major grocery retailers in appropriate circumstances.

Pricing and promotional practices

The major grocery retailers have indicated that they intend to decrease promotional pricing and increase their use of "everyday low pricing". We consider that they could also improve the clarity of their promotions and pricing practices in other ways and we describe this in our recommendations.

We consider that more consistent use of unit pricing would benefit consumers and we recommend making it mandatory through the use of a Consumer Information Standard implemented under the Fair Trading Act.

Increased transparency for loyalty programme terms and conditions

We also recommend that major grocery retailers take voluntary steps to ensure that consumers are better informed about the terms and conditions of participation in their loyalty programmes, particularly those relating to data use and collection practices.

Have your say

Our draft report is now open for consultation. We invite comments on any aspect of it, including any issues you consider relevant that we have not covered.

Like the preliminary findings expressed throughout this report, our options to improve competition are subject to consultation, further analysis and deliberation, and we may alter or remove any option when we finalise our recommendations.

You can have your say via our website at www.comcom.govt.nz/groceries. Comments close at **4pm on Thursday 26 August 2021**.

We will also be holding a consultation conference in Wellington from **21-24 September 2021**.

Further comments, including on matters raised at the conference and in published comments made by others, are due at **4pm on Thursday 7 October 2021**.

Feedback will be considered in preparing our final report which is required to be published by 23 November 2021. After that, it is up to the Government to decide how to respond.

