COMPETITION/REGULATION

How the govt might **deal to the supermarket** duopoly

Persistently high profits are earned by the major grocery retailers, while the prices for groceries in New Zealand are higher than those overseas and New Zealanders face some of the highest grocery spend per capita statistics in the OECD

Gary Hughes

The emerald isle of Ireland has a team of just under five million, like New Zealand. Consumers there have a set of five main supermarkets to choose from, with the largest having 22% market share.

New Zealand has just two (and a lot fewer pubs). The ASX-listed Woolworths and the Foodstuffs co-operative chains combine to take more than 90% share of households' main weekly shop, in what is a $22 billion industry.

The Commerce Commission (CC) has spent nine months exploring why this is, how it came about, what detriments it brings to competition and, most importantly, what might be done about it.

The draft report into the retail grocery sector is the CC's second large market-specific competition study. It confirms what competition lawyers long knew: that duopolies tend towards bad economic outcomes, with a competitive détente or game of anticipated stalemate moves often developing. Having only a few fringe or specialist competitors, such as in the grocery trade, is not enough to lead to effective and workably competitive outcomes for consumers.

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Jurisdiction and process

Traditionally, the CC has been an enforcement body, taking action to enforce compliance based upon complaints or its own monitoring actions. It enforces Commerce Act provisions against anti-competitive behaviour or acquisitions, the Fair Trading Act and consumer laws, and a growing number of legislative-specific regulatory price controls.

In 2018 it was given new powers (part 3A of the Commerce Act) to conduct a deep dive into whether there are factors that may prevent competition from working well in particular markets. The CC can use its statutory information demand powers to study and gain insights into market structure, profitability levels and supply chain arrangements. This is broader than a confined enforcement investigation.

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David Clark, the Minister of Commerce & Consumer Affairs, requested this year-long competition study under s 51 of the Act in November 2020, asking the CC to focus on these (non-exhaustive) matters:

- the structure of the grocery industry at the wholesale and retail levels;
- the nature of competition at the wholesale and retail levels of the grocery industry;
- the pricing practices of the major grocery retailers;
- the grocery procurement practices of the major grocery retailers; and
- the price, quality, product range and service offerings for retail customers.

After initial consultation on scoping and preliminary issues, the CC has issued an explosive draft report.

Preliminary findings

Presenting the report to media on 29 July, CC Chair Anna Rawlings emphasised that competition in the retail grocery sector is not working well for consumers or, for that matter, for suppliers to Woolworths NZ and Foodstuffs.

That is predominantly because the structure of the market over time has come to be a duopoly and a diverse fringe of other grocery retailers have only a limited impact on competition. They are unable to compete with the two main retailers on price and product range in order to satisfy the demand from most New Zealanders who still prefer to buy groceries during a main shop in one location. For around 90% of us, that location will be one of the triple branded store chains owned by the duopolists.

The CC observed evidence that there are persistently high profits earned by the major grocery retailers, while the prices for groceries in New Zealand are higher than those overseas and New Zealanders face some of the highest grocery spend per capita statistics in the OECD.

Additionally, supermarket innovation levels are modest. The high profits do not appear to represent rewards to invest in innovation. Further, it is not clear that aggressive leveraging of buyer power against small suppliers (against mortal fear of their products becoming 'de-listed') is being passed through to consumers.

Out of OECD countries, New Zealand ranked sixth highest in terms of grocery prices, as well as fourth and fifth highest in terms of grocery expenditures in the OECD and ICP datasets respectively.

Economists' models suggest that in a duopoly each provider can coordinate their behaviour (without direct collusion) to sustain higher prices and profitability at higher levels than are attainable in a

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> **In a duopoly, each provider can coordinate their behaviour without direct collusion to sustain higher prices and profitability at higher levels than are attainable in a competitive market**

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competitive market, to the detriment of consumers and efficiency. The CC describes this in terms of rivals 'accommodating each other's behaviour', resulting in little need to compete on price, especially with each having multi-supermarket brands in differentiated spaces.

More options

Entry into New Zealand's grocery market is challenging. There have been no new large-scale retailers since The Warehouse Group's attempt in 2006 to develop a 'Warehouse Extra' chain of supermarkets.

At that time, the duopolists each took a blocking stake of 10% in listed Warehouse shares. They then applied to the CC for clearance under s 47 of the Act to move to a full takeover. The CC refused. But a High Court appeal overturned that, finding the Warehouse Extra concept faced many challenges and was likely to fail. So it could not represent effective competition to the big two.

The Court of Appeal reversed that decision ([2008] NZCA 276), agreeing that if the CC could not have sufficient evidential certainty that a three-into-two merger would not substantially lessen competition, it was entitled to refuse to grant clearance. After that, the minority owners sat on their 10% each and within two years The Warehouse Group discontinued it.

Chapter six of the draft report is one of the most crucial, getting to the heart of difficulties for new players entering or fringe players expanding. There is a lack of suitable large-format sites for new stores and the wholesale levels of the market are largely controlled by the big two: even smaller retailers like dairies said they resupplied from existing supermarkets. These factors mean that under current market conditions only small-scale entry is viable, which has a limited impact:

> It is unlikely that any new grocery retailer with a similar retail offer to the major grocery retailers will, under current market circumstances, enter at the scale required for effective competition for consumers' main shop.

Large US wholesaler/subscription Costco is due to open a store in 2022, to some extent improving choice for consumers in Auckland. But the CC thinks market conditions will not significantly improve for consumers as a whole, with Costco targeting only niche consumer groups. Notably, international giant Aldi is growing in Australia but, despite having registered New Zealand trademarks years ago, has shown no signs of entering the market.

The CC understands large-scale entry may be unlikely due to factors like the small size of the New Zealand economy and a population profile which restricts the number of centres where a supermarket can be profitably operated. But land-banking by the big two, along with restrictive covenants and use of property law restraints, plays a big part:

> The availability of land for new entrants and existing firms is reduced by difficulties in getting planning permission to develop potential sites and conduct by the major grocery retailers relating to property, including how they use restrictive covenants on land and exclusivity covenants in leases to prevent other supermarkets operating.

Recommendations

The CC provided a range of options to improve competition. The media is excited by the prospect of a forced divestment or break-up of big players, similar to the Telecom/Chorus structural separation legislation of 2006. Old-fashioned trust-busting in the US sense (of dismantling big steel and oil trust companies, by which competition law there became known as 'anti-trust') would be dramatic but is the least likely outcome.

A more realistic set of steps could improve the conditions for entry and expansion by rival retailers by trying to crack open access to wholesale-level groceries, or make more large sites available for retailing. The CC says:

> We consider that the best options for improving competition are likely to be those that enable an increase in the number of firms competing in the retail grocery market. In the long term, threatened and actual entry or expansion is likely to be the greatest driver of competition in grocery markets.
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> The first way this could occur is through measures to improve the conditions for entry by new grocery retailers and expansion by existing retailers. These include measures to improve

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access to a wide range of wholesale groceries at competitive prices, and measures to make sites for grocery retailing more readily available through possible changes to planning laws and restrictions on the use of restrictive covenants.

There are enforcement investigations the CC could be given along those lines. But other steps towards facilitating or creating entry by major retailers falls to government. Expanding the duopoly to an oligopoly is still imperfect, but better. Legislative changes may affect restrictive covenant laws, allowing direct sponsorship or investment by central/local government or even requiring existing chains to sell some stores in particularly concentrated retailer towns.

There is also a power imbalance between the supermarkets and their suppliers. A mandatory code of conduct for fair treatment of suppliers would seem a no-brainer for Clark. However, changes to allow collective bargaining by suppliers would risk cutting across recently toughened cartel law and CC educational efforts to discourage sellers colluding.

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Lastly, measures directed at improving the information provided to consumers (for example, compulsory clear unit pricing) would help us all make informed purchasing decisions.

Next steps

These draft findings are preliminary, but powerful, and there is not a lot of time for submissions. This competition study has flown under the radar for much of 2021, with only the main food supplier trade body lined up against the two supermarket groups. But as publicity and political pressure now become intense, completion of the final report is due in November.

Given how far-reaching the proposed outcomes could be, you may expect a fierce circling of arguments, wagons and expert witnesses by Woolworths and Foodstuffs. It will be in other food sector players' interests to emerge in numbers for participation in the final stages.

Consumer groups, and other grocery players large and small, will be watching with interest (Walmart, anyone?) to see if better scope for market entry in future will really materialise. Lawyers with food industry clients should note that written submissions on the draft report close **26 August 2021**, followed by an in-person conference hearing in Wellington on 21-24 September 2021.

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