Three pages on supermarkets

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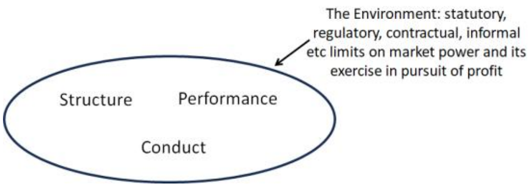
This three page report on supermarkets is addressed to the questions
- what makes the grocery sector uncompetitive?
- what is to be done?

The policy context is "a growing consensus around the need for more robust interventions, potentially including the breaking up of the duopoly".

The first page critically evaluates two pieces of policy advice: the Westpac May 2023 paper[1] and the Commerce Commission report[2]. The second page (which spills over to p.3) sets out a model of the industry structure. The third page cautions against indiscriminate use of an axe to "fix" a market structure which could benefit from a bit of scalpel (targeted surgery) but where the real issue is Conduct.

There are four interacting characteristics of any market that frame my analysis: Structure, Conduct, Performance and institutional Environment. Diagram:



Structure, Conduct and Performance interact within the constraints and opportunities set by the Environment.

1. <u>The Commission and Westpac studies</u>

The Westpac report correctly identifies the historic source of the problem (Environment) but then embarks on a facile and reckless scheme of Structural change that doesn't address the identified source of the problem, and accepts potentially serious short-run harm to consumers and consumer surplus in pursuit of hypothetical long-run gains which are nowhere demonstrated. The correct (though incomplete[3]) diagnosis is on page 5 of the Westpac report (my emphasis):

> The industry, **<u>sanctioned by regulators</u>**, has actively pursued economies of scale through mergers and acquisitions (and hence horizontal and vertical integration) since the early 1980s. The impact has been to give the duopoly the kind of control that makes it much easier to set prices at the checkout till.

In short, the regulatory environment allowed Conduct to become toxic, with some Structural changes on the side. The proposed solution is to ignore the Environment but smash the Structure. I interpret this as a transparent big-business attempt to persuade Government to take its eye off the regulatory ball and embark on a destructive bout of axe-wielding, at the short-run cost of consumers - "we acknowledge that breaking up the existing retail hegemony … may impose short term costs on customers". Throwing consumers onto a bonfire along with the supermarkets does not look like sound policy to me.

The Commerce Commission, in contrast, never explains the historical emergence of uncompetitiveness in the supermarket sector; the Commission simply documents its existence in the present. Despite the lack of any historical perspective, the Commission correctly focuses on the regulatory Environment as the basic problem,

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1 Grocery retailing in New Zealand, *Westpac Economic Bulletin* 12 May 2023, https://www.interest.co.nz/sites/default/files/2023-05/westpac-grocery.pdf.

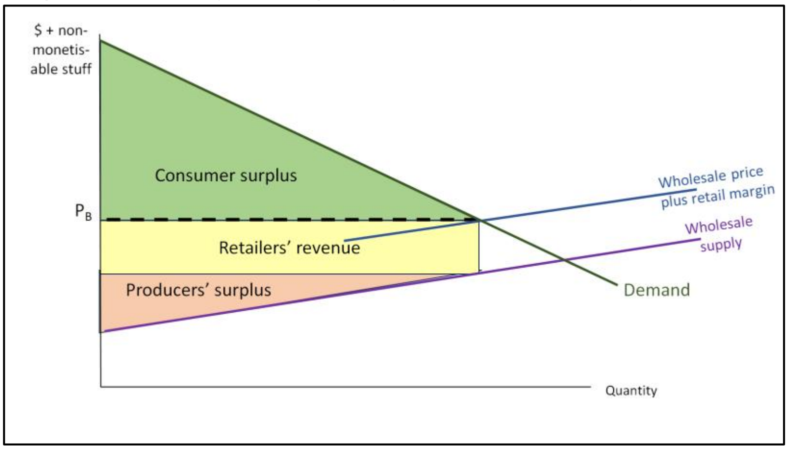
2 Commerce Commission, *Market study into the retail grocery sector: Final report* 8 March 2022, https://www.comcom.govt.nz/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf.

3 Westpac here neglects to mention predatory and exclusionary conduct.

and recommends overturning, replacing or tweaking selected bits of the Commerce Act 1986, while leaving the basic scheme of that Act unchanged. The Commission has been correctly (in my view) criticised for spinelessness; the difficulty is that its spine was surgically removed by the Commerce Act 1986 and will not magically reappear just by giving it carefully-circumscribed powers to oversee the conduct of players that are well versed in the art of regulatory capture and evasion, and familiar with the extraordinary latitude the 1986 Act allows for transparently anti-competitive conduct. If radical and dramatic policy change is really sought, the scheme of the Commerce Act requires attention.

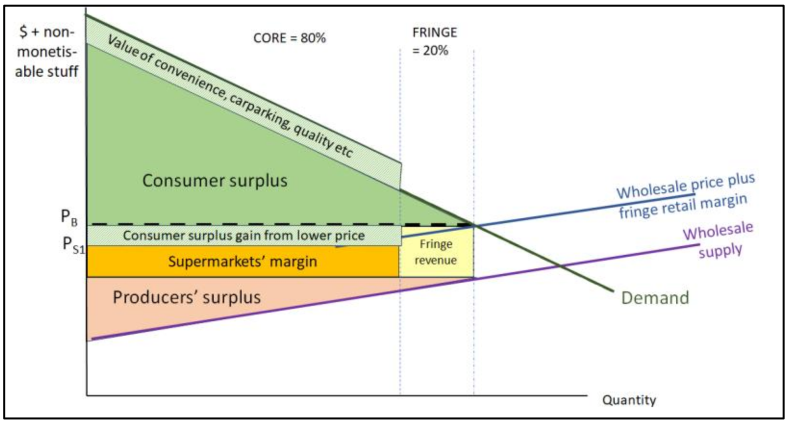
2. Modelling supermarkets

Diagram 1: a competitive grocery market without supermarkets:



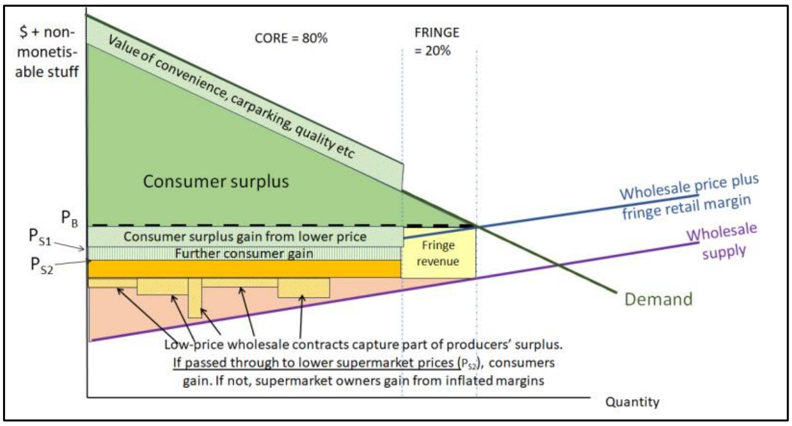
The benchmark price P_B is set at the margin of the market among independent retailers who are intermediaries and just break even. Surpluses accrue to consumers and producers.

Diagram 2: supermarket(s) as a competitive success story and a win for consumers:



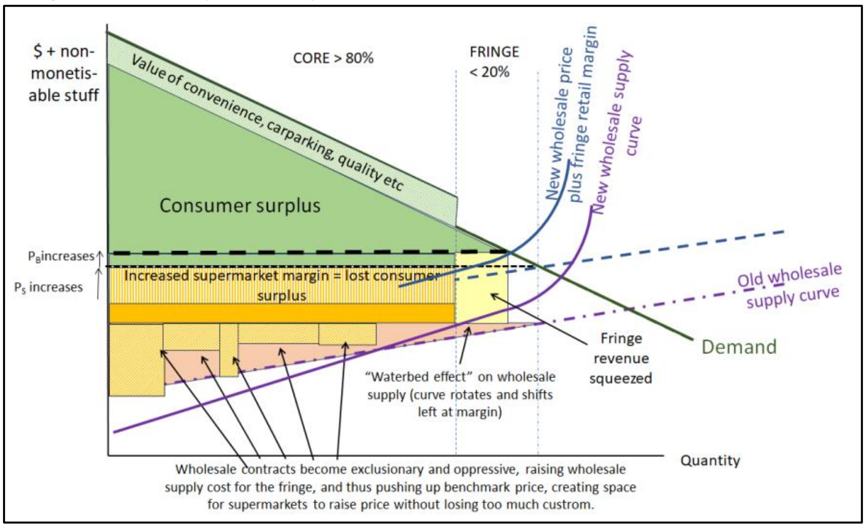
Supermarkets undercut the benchmark price P_B which continues to be set at the margin, and which remains the upper limit to the supermarket price P_{S1}. Supermarkets gain market share and customer loyalty through lower price and enhanced quality (including carparks, convenient location, etc etc). Consumers gain two chunks of extra surplus: one from lower price and another from improved shopping experience

Diagram 3: supermarkets exercise some monopsony power for the benefit of consumers – a win:



Supermarkets leverage their bulk-buying ability to capture some surplus from producers, passing the gains through to lower prices. Supermarket gross margin now is the sum of the darker yellow areas (add contract gains below, subtract effect of price fall from P_{S1} to P_{S2}). If supermarket margin remains unchanged, this is a welcome transfer of surplus from producers to consumers. That's more likely if there is competition among supermarkets for shares of the 80% market, and unlikely if there is no competitive pressure (unless a monopoly supermarket is run by a non-profit – which poses quality risks for consumers).

<u>Diagram 4</u>: with predatory conduct unchecked, this turns to custard:



By predating in the wholesale market, thereby shifting the Fringe's wholesale supply curve up and to the left, the supermarkets can drive up the benchmark price - manipulating the market margin. This clears space for supermarkets to raise prices and profits while still staying below the benchmark price. Consumers lose from higher prices, reduced retail options in the fringe, and likely fall in supermarket performance as supermarkets get fat and lazy. Tacit collusion between duopoly players removes discipline on P_S. Market study triggered.

Key points:

- Vertical integration is partial, not complete: these are intermediary businesses between producers and consumers. Contrast with full vertical integration (oil companies, electricity gentailers).
- Therefore genuinely constrained above by "residual demand" (the benchmark price from the market margin) and below by the producers' supply curve for groceries.
- Supermarkets operate <u>inside the margin of the market</u> for groceries, under the shelter of the benchmark price: therefore they are (i) externally constrained by a market price (=residual demand curve) set at the margin, not directly by themselves; and (ii) strongly incentivized <u>not</u> to increase their market share beyond around 80-90% because they need the fringe for shelter.

3. <u>What this means for policymakers</u>

- Be very cautious in responding to populist, and especially neoliberal, calls for Structural break-ups to solve Conduct problems, however attractive the short-run politics may look.
- The crucial area of predation appears to be in the wholesale space. Consider taking sections 22 and 23 of the Commerce Act 1975 and inserting them into the Commerce Act 1986. (Better still, dump the latter for an updated version of the former.)
- I agree with the Commerce Commission that there is scope for some horizontal break-up, partly to stop (e.g.) Countdown's blocking of competitors by occupying multiple adjacent sites (see Tex Edwards' submissions to the Commission, and take a look in central Napier). But remember that forcing divestment of <u>sites</u> need not result in another supermarket, since once on the market, land has many uses. Even forced divestment of store may not produce a result. Don't overestimate what Government can control in a private marketplace.
- There is a lot of scope for the competitive process to clip the supermarkets' wings if given a chance, but this <u>does not involve taking an axe to the supermarkets at consumers' expense</u>. Genuine competition can come from the fringe as well as from new entrants, and it is complaints from the fringe that deserve most attention as a guide to policy. An example of a fringe that took over from a duopoly is craft beer. In grocery, stronger fringe competition will affect price but may have muted impact on market share.
- With grocery (i) there is a genuine distinction (with attached consumer surplus) between bulk shopping at the supermarket and "top-up" or "last-minute" shopping in the fringe; while (ii) the supermarkets have a strong strategic vested interest in the survival of the fringe as the benchmark price-setter against which they can discount. They won't eliminate the fringe, but they have to be prevented from manipulating it - and the market margin - to their own advantage.

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