the state of
COMPETITION

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Private labels are increasingly prominent on our supermarket shelves. The ACCC thinks this is okay – if consumers don't like it, they'll vote with their feet. But does that reflect the reality of the Australian grocery market? In this, our first edition of The State of Competition, Alexandra Merrett and Rhonda Smith examine the relationship between private labels, copycat products and buyer power.

Crying over spilt milk: buyer power and the rise of private labels

A funny thing's been happening at your local supermarket lately. Check out your favourite product, and you may well find that there is a copycat sitting right alongside it. Imitation is the sincerest form of flattery, but imitation in branding has a tendency to prompt litigation. Red Bull, Twisties and Maltesers are all brands that, over recent years, have been party to passing-off actions (with mixed success). But here, it's the distributor – that is, the supermarket – that seems to be the culprit. Increasingly, private label products are adopting very similar get-up to market leaders and are getting prominent shelf space beside their better known – and generally more expensive – competitors.

Competition for shelf space has long been intense. Now, however, supermarket suppliers are having to compete directly with their retail outlet for space. With competition between Woolworths and Coles increasingly fierce, suppliers are feeling the heat. *The Age* (26.03.12) recently reported Heinz's view that the Australian market is "the most difficult and inhospitable" of those in which it operates. In the same article, an ex-Fosters executive said it was the toughest climate he'd seen, and another large manufacturer spoke of 'cliffing' – "where suppliers were asked to stand at the edge of a cliff and agree to certain discounts and if they didn't, they were told to look over the cliff and see if they liked it better".

Supermarket suppliers are having to compete directly with their retail outlet for space

If this is the general assessment of market conditions, is it any wonder that suppliers aren't suing copycats, when the copycats in question also happen to be their major customers?

Why the sudden focus on private labels?

Private labels (also known as generics or home/house brands) have been on Australian shelves since at least the 1960s. Although bearing the supermarket's brand, these products are typically produced by specialist companies that may also sell their own proprietary products. In Australia, private label products

have generally had a poor reputation for quality, albeit with commensurate pricing. The ACCC summarised their position in the market thus: "Sales of these private label products were historically relatively low, received limited consumer acceptance and offered little competitive threat to suppliers of branded products".

In other countries, however, private labels are much more accepted. According to IBISWorld, private labels account for more than a third of sales in the US grocery market and more than half in the UK. With margins on private label products considerably more attractive, it's little wonder that the Australian chains have been keen to increase their presence on the shelves. The arrival in Australia of ALDI – which has a business model premised on the European acceptance of home brands – appears to have prompted a renewed interest in private labels.

It's not just the packaging, it's the placement...

And it seems to be working. IBISWorld estimated private label sales in Australian packaged groceries at around 12% in 2007; now they account for 20% of annual grocery sales for the two giants, Coles and Woolworths, and constitute almost a quarter of the market overall. This growth appears due to a number of things: 1. a focus on products which are perceived to be generally homogenous (largely eliminating concerns about quality); 2. a tiered approach, whereby some cheaper/lower quality labels are introduced, together with a label to take on the market leader head-to-head; and 3. increased market power on the part of the major supermarket chains, allowing them to manoeuvre both suppliers and customers into supporting private labels.

Milk: the first frontier

Private labels appeared to re-emerge in a big way when milk became the vanguard of Coles' "Down down" campaign. Woolworths quickly followed Coles' pricing, and all of a sudden milk was $1 a litre. There were a number of factors that meant milk was a suitable candidate to lead the campaign: it's perceived to be homogenous,[1] so customers aren't so concerned about quality; it's one of a few price-setting products used by customers to assess the overall competitiveness of supermarkets; and deregulation at the turn of the millennium had resulted in excess capacity, leaving producers tendering for private label contracts at very low prices just to ensure they were better able to cover their ongoing costs.

1 Yes, we enjoyed the pun too.

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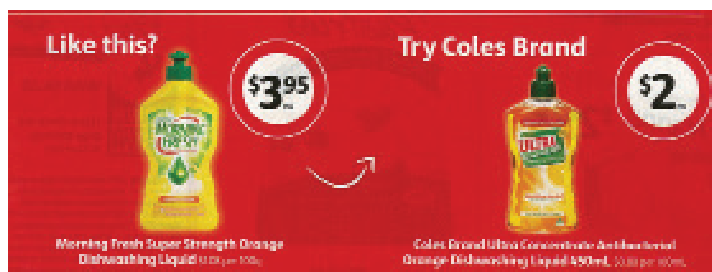
There's no doubt Coles' move has been successful. When investigating the impact of private labels in the milk industry, the Senate Economics References Committee (**SERC**) reported that private label sales had increased from 22% in 1999-2000 to about 50% in 2009-10. For plain fresh white milk, private labels now account for approximately 70% of sales.



...and the promotion.

Prices are so low that it's been asked whether they are in fact below cost. National Foods (whose proprietary brands include Pura and Dairy Farmers) disclosed to the Senate that its margin on Coles' and Woolworths' private label milk was close to zero and that, prior to a price increase in January 2011, they had been making a loss on their Coles contract. It's also widely perceived that the price of private label milk is eroding – for good – margins available on branded milk. While Coles argued that it was taking the brunt of the price cuts, others suggest that it's inevitable that processors, and ultimately farmers, will end up suffering. As Woolworths submitted to the Senate, "this price move has effectively re-based the price of white… milk across Australia overnight, and for an unknown period into the future, which also potentially devalues the whole milk category in the eyes of the consumer. In effect, the consumer baseline for price is now at 1990s levels, but with 2011 input costs for all parts of the supply chain".

Why sign your own death warrant?

We've all seen the supermarket staff offering to help customers through the self-serve counters, working hard to make their jobs redundant. Milk processors signing up for private label contracts at such low prices seem to be similarly trapped. The obvious question, then, is why do it? In its *Grocery Report*, the ACCC identified three basic reasons for the processors bidding for private label contracts:

- overhead recovery – generating revenue through private label sales to contribute to the business' fixed costs;

- supply relationships with retailers – supplying private label products provides a stronger relationship and possibly improves processors' bargaining position in relation to branded products; and

- volume – the volume of milk supplied through private label contracts provides some stability to the business.

A key driver here may be the problem of excess capacity (also a critical issue in *ACCC v Safeway*). During a sustained period of excess capacity, it doesn't seem as though the processors have a lot of choice but to try to win these contracts from the supermarket chains. A witness before the Senate argued, "Who is their other market? We have National Foods with a billion litres, if they do not supply Coles and they do not supply Woolworths, who are they going to sell that billion litres to?".

Symptoms of buyer power

So the question arises: is the pricing of private labels – as well as their get-up, positioning and general promotion – related to buyer power? Buyer power, like any market power, occurs along a continuum: there can be absolute buyer power (monopsony), but also significant power falling short of monopsony. Three key ingredients influence the extent of buyer power: the market share of the buyer; the price elasticity of the relevant product; and, finally, the height of barriers to entry into the downstream (eg retail) market.

Applying those factors to milk, the ACCC reports that Coles and Woolworths account for 70% of packaged grocery sales in Australia and approximately 50% of fresh product sales. Coles estimates its own share of the drinking milk market to be about 17% (the same sort of number that got Woolworths into trouble in *ACCC v Safeway*). The higher the market share, the fewer options a supplier has for replacing that buyer. So, if one were to lose a Coles contract, just who could step in to take the volume of milk on offer? Market share is particularly important where the supplier depends on the buyer to 'underwrite' its cost of production by providing access to economies of scale. Even where there are multiple buyers, if sales to a particular buyer cannot be replaced, that buyer has buyer power. This factor is exacerbated where there is significant excess capacity.

Buyer power is also likely to be greater if supply is relatively price inelastic. This is because a significant reduction in price can be achieved without causing much reduction in the amount supplied. The buyer may have to accept a small reduction in supply to gain a price decrease but would not be prepared to accept a large reduction. In the case of dairy, farmers can't easily adjust their output in a given week because prices are down. Their output is, to a large extent, determined by the size of their herd, something which can only be adjusted over a longer period of time.

Finally, buyer power requires barriers to entry into the

The dairy industry isn't what it used to be.

downstream market to be significant. If suppliers can't bypass the buyer – for example, by selling directly to customers or through sponsoring new entry – then their lock-in is complete.

In addition to these factors:

- fringe players, such as ALDI, struggle to get customers to switch even in response to an exercise of buyer power by the chains, due in part to less attractive formats and higher unit costs;

- suppliers have to compete hard for access to limited shelf space – competition which has intensified due to the major chains' policy of having just two or three national suppliers in each product category, as well as the aggressive promotion of their own labels; and

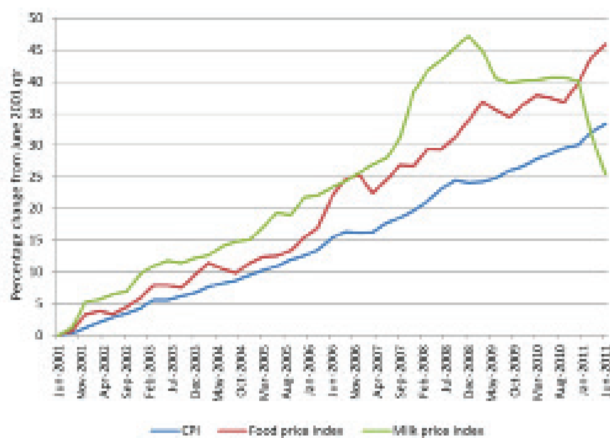
- consumers are generally more loyal to a store than to a brand so, if a particular brand is de-listed, they will most likely switch to another rather than go elsewhere.

Looking at these factors, the position of Coles and Woolworths seems clear. Indeed, in similar circumstances, the Full Federal Court in *ACCC v Safeway* determined that Woolworths/Safeway – and implicitly Coles – had substantial market power. In addition to bringing those proceedings, the ACCC has conducted many investigations into the sector over recent years, clearly demonstrating its ongoing concerns.

True or false: the competitive effects of buyer power are ambiguous?

If a monopoly tends to under-supply in order to drive prices up, the converse is true of a monopsony. It may over-buy, forcing prices down, or it may under-buy in order to force some change on the market. Where there is an over-buying strategy, consumers often appear to be the winner. The ACCC summarised the position thus:

The buyer power of Coles, Woolworths and Metcash may adversely affect individual competitors. However, the role of the ACCC is to consider competition, not individual competitors. There is no significant evidence to suggest that innovation or competition at the supplier level has been damaged. Further, consumers can benefit from buyer power in the form of lower prices.



Movements in the CPI, food price index and milk price index

Similarly, the SERC observed that "The fact that consumers are saving over $1 million dollars a week on what is, for many, a basic staple is not a benefit that should be dismissed lightly". It reproduced a figure (above) showing the movements of the CPI, food price index and milk price index over the past ten years, clearly demonstrating the upside for consumers.

When considering the role of private labels in its *Grocery Report*, the ACCC identified four key concerns:

- retailers may allocate premium shelf space to their own brands in preference to competing suppliers, which could affect competition at the retail level;

- branded products may be de-listed to make way for private labels, which could affect competition at the supply level;

- private labels may weaken incentives for product innovation; and

- the impact of 'copycat packaging' of private labels.

When considering each, its conclusions were often at odds with the arguments it has run in other circumstances. For example, while acknowledging evidence that supermarket chains favoured their own products, the ACCC appeared to accept Woolworths' claim that this couldn't go too far – if customers couldn't buy what they wanted, they would go elsewhere. "There is little evidence that [the major supermarket chains] are able to override consumer preferences because if they were to do so, *they would risk losing customers to other retailers*" [emphasis added]. Of course, the limited ability (or willingness) of customers to do so was a foundation stone of the ACCC's case against Safeway, and is the premise upon which many investigations or merger assessments have proceeded.

As such, private labels were generally seen by the ACCC to be pro-competitive, encouraging price competition. Any adverse impact on dynamic efficiency – i.e. investment and innovation in the industry – was dismissed. The ACCC summarised this issue as follows: "The theoretical concern is that if private label sales increase at the expense of branded products, suppliers of branded products may have lesser incentive and ability to undertake new product innovation as expected returns would be lower". With respect, this does not capture the full problem. When there is excessive pressure on margins, there is no money available with which to innovate.

In its submission to the SERC, Fonterra observed "developing market leading dairy brands with consumer positions around health, wellbeing, superior nutrition, taste and convenience, requires significant investment in research and development". One of the very reasons why private labels are attractive, however, is there is less investment required (particularly when one free-rides on the market leader's reputaiton, eg by copying their get-up). Woolworths submitted to the ACCC that a "[p]rivate label doesn't carry the cost of marketing that branded product do[es], we can clearly make a better margin and yet deliver it to the consumer at a lower price". Some of that cost of marketing relates to product differentiation – a form of competition closely related to on innovation. So yes, price competition may drive innovation that will lower production costs for mouse traps; but when margins are squeezed too tight, there is little left in the kitty to invent *new* ways to rid yourself of rodents.

Finally, in regard to copycat packaging, the ACCC said the issue was not supported by sufficient evidence to warrant close scrutiny. But we are not the only ones to have noticed this issue. Indeed, the April edition of *Choice* devoted an article to the issue, complete with this website showing a number of examples. The increase in copycat packaging that we have observed recently may largely date since the delivery of the *Grocery Report* in mid-2008, but it's unfortunate that the ACCC dismissed the issue so summarily.

Ultimately, the ACCC recognised that there were some potential problems, particularly in relation to the preferential treatment of private labels as against branded products. But it concluded that competitive pressures protected consumers: "to remain competitive, retailers must continue to deliver products that consumers value, or risk seeing their customers shop at other stores". Some of the evidence the ACCC relied on in reaching this view seemed ambiguous at best: "Indeed, much of the evidence… shows that suppliers of rival branded products typically react competitively to the introduction of private label products". Companies targeted by a predatory pricing strategy also tend to respond competitively so one wonders what, exactly, this point proves.

Answer: false (in the long term)

As Noll observes, "[t]he exercise of monopoly power almost always causes inefficiency and always harms at least some consumers; the effects of monopsony are basically the same". These effects, however, generally occur at a 'distance' from the cause: the harm might be felt in another part of the supply chain and/or may take some time to fester.

For example, producers who are 'squeezed' by the supermarket chains may themselves be able to exert buyer power in relation to some of their suppliers. As such, farmers were just as concerned by Coles' pricing strategy as were processors – they realised that, sooner or later, their margins would be affected. The SERC expressed its specific concern at the "speed and ease with which a certain group of [contracted] farmers... were affected by the cuts in the retail price of private label milk..." as a consequence of Coles' pricing.

As returns diminish, investment is likely to reduce. This is likely to impact on dynamic efficiency. The trouble with stifled innovation, as noted by **Prof Mark Bauer** at a recent Melbourne Law School **CLEN** event, is that you don't know what you're not getting. It's somewhat like getting your first pair of glasses – until you put them on, you didn't realise what you were missing. During his brief visit to Melbourne earlier this year, Prof Bauer lamented our lack of pre-washed and pre-cut salad vegetables such as his personal favourite, **waffle-cut carrots**. His Australian audience was somewhat

IGA's recent advertising campaign

bemused, but this example illustrates a broader point. There's such limited competition in our grocery sector that innovation which tests the scope of customer preferences is not necessary nor – if suppliers' margins are squeezed too much - affordable.

Consequently, as with monopoly power, an exercise of buyer power generally damages the competitive process and, directly or indirectly, harms consumers. Because of the distance between the cause and effect, however, regulators do need to pause before intervening. Again, like predatory pricing, consumers may well benefit in the short-term and there could be scope for market correction before long-term harm occurs. But market correction needs to be foreseeable, and that requires low barriers to entry. Accordingly, the notion that consumers must want private labels otherwise they would vote with their feet suggests a confidence in competitive forces in the grocery sector that the ACCC does not generally project. Indeed, IGA's new campaign "We stock your favourite brands" suggests customers' preferences are not being met. It's just a pity that, as everyone – including the ACCC – acknowledges, IGA stores don't adequately constrain the big chains.

About the authors

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Further reading

If you'd like to know more about this topic, you might find the following publications interesting:

• Rhonda L Smith and Alexandra Merrett, "To buy or not to buy: economic and legal reflections on buyer power" (2006) 14 *Competition and Consumer Law Journal* 100

• RG Noll, "'Buyer power' and Economic Policy" (2005) 72 *Antitrust Law Journal* 589

• Economics References Committee (Senate), *The impacts of supermarket price decisions on the dairy industry* (final report) (November 2011). Available at: http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=economics_ctte/dairy_industry_supermarket_2011/report/index.htm

• Australian Competition and Consumer Commission, *Notice in respect of a notification lodged by Nestle Australia Ltd N31488* (3 August 2006). Available at: http://www.accc.gov.au/content/index.phtml/itemId/717314/display/acccDecision

Acknowledgements:

• Adele Ferguson, "Risks for big boys in bleeding suppliers" (26 March 2012) *The Age*

• IBIS World, *Special Report: Australia's appetite for private labels to grow* (2010)