

Retail Pricing Increases Exaggerated

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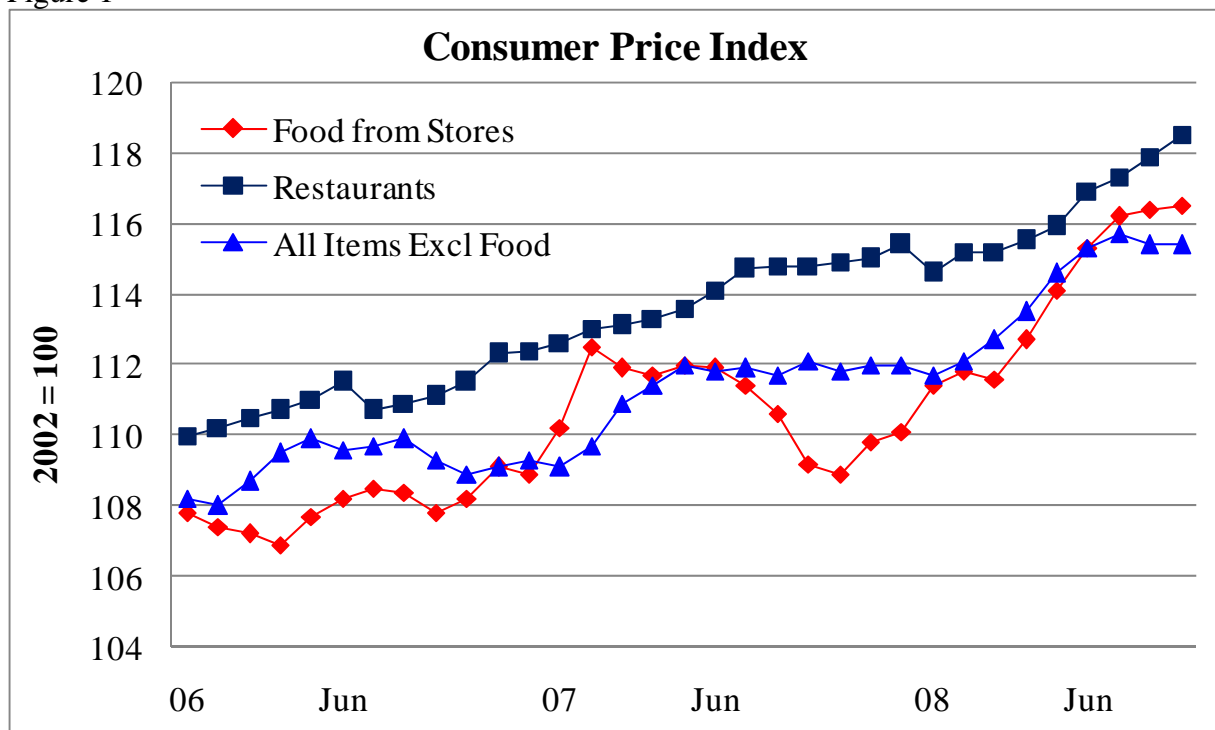
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There is no doubt that the price of food purchased from stores has risen significantly over the past several months. However, it is important to put those increases into perspective by examining the contributing factors. The purpose of this paper is to provide such context, and to determine whether this upward movement in food pricing will soon come to an end.

The price of food purchased from stores jumped dramatically in September 2008. The year over year increase in the Statistics Canada Consumer Price Index (CPI) for Food Purchased from Stores for the month amounted to 7%. The CPI measures price changes at the consumer or retail level. The year over year increase in the price of all items, excluding food amounted to 3%. The cost of food purchased from restaurants also increased by 3%.

That 7% increase in the cost of food from stores is the biggest increase in at least ten years. The only time increases came close were the 6% increases for three consecutive months in 2001. For the ten years from 1998 to 2007, the average monthly year over year increase in the price of food purchased from stores only amounted to 2%. During that time, year over year decreases were common. Figure 1 shows the CPI for food from stores, all items and restaurants from 2006 through September 2008.

Figure 1



Within that context, however, the graph tells a better story than the words or arithmetic. The fact is that the big increase in year over year pricing is primarily due to the fact that last year at this time, pricing at stores was actually dropping. The graph shows that last year at this time, the food from stores pricing was declining significantly due, at least in part, to the significant appreciation in the Canadian dollar late last year. That appreciation resulted in much lower costs for imported and domestic fresh fruits and vegetables.

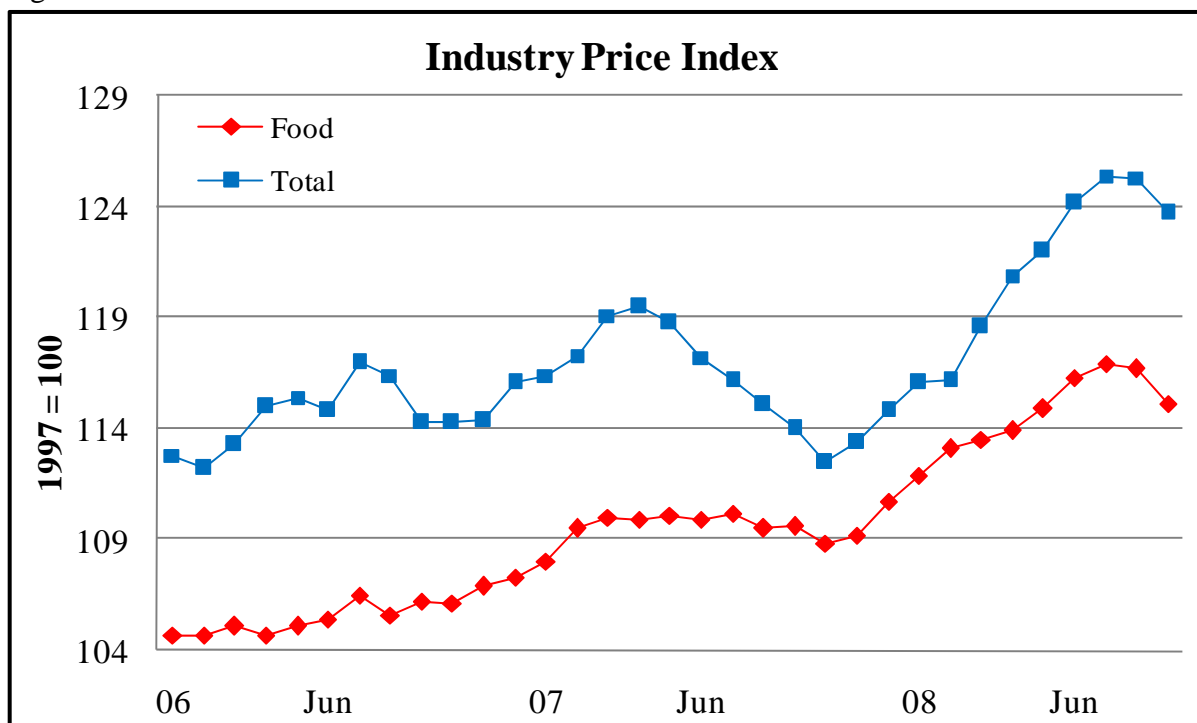
With that perspective noted, it is not surprising that the biggest year over year increases in pricing this September were in fresh fruits and vegetables. Those two categories increased by 13% each this year compared to last. The other main items within the food CPI such as meat, poultry, dairy, coffee, and frozen food, all increased by healthy 3-6% margins. In other words, food from stores increased by material amounts, but the big 7% increase was largely due to the C\$ impact on fresh fruits and vegetables last year.

The only exception to that generalization was bakery products. Bakery products increased by 14% in September 2008. Bakery products also increased by 14% for the third quarter this year, versus the third quarter last year. That increase was due to the big rise in commodity wheat costs, either directly due to increased costs or indirectly due to the pervasive view that higher wheat costs lead to higher bakery costs.

Wholesale Pricing Sags

The Industry Price Index (IPI) measures the changes in pricing at the wholesale level. The IPI measures price changes for the manufacturing sector. The IPI for food manufacturing increased 5% this September compared to September 2007. Unlike the CPI for food purchased from stores, the food IPI actually declined from August into September.

Figure 2



In addition, during September the food IPI rose less than the non-food IPI. Figure 2 shows the food and total non-food industry IPI's from 2006 through September 2008.

Based on the IPI and CPI data, it appears that supermarkets have taken pricing increases to bold new levels during the past quarter. For example while chicken prices declined sharply in the third quarter at wholesale, poultry retail prices increased by 4%. Dairy pricing increased just 2% at wholesale during the third quarter and 4% at retail. Pre-cooked frozen food increased 1% at wholesale and 3% in store. Coffee pricing was flat at wholesale but up 3% at the grocery level. As mentioned, bakery products had a big 14% jump in the third quarter at retail but there was only a 5% increase at wholesale.

As noted above, most of the pricing increases at retail were likely due to the fact that the dollar appreciation in late 2007 resulted in lower produce costs. In other words the increase this year was made more noticeable due to the decrease last year. Nevertheless, based on the observations of manufactured food items, it appears that grocers have been able to add to their margins during the past quarter. This suggests that the claims of an intense competitive environment in the Canadian supermarket sector, particularly due to Wal-Mart, may have been overstated. To be fair, however, this development may have been isolated to the third quarter. During the second quarter, wholesale food prices increased by 5% compared to only 2% at the store level. In other words, second quarter margins suffered while gaining back some ground in the third.

All in all, the price increases at the store level are likely to be a short-lived reprieve rather than a longer term trend toward stronger margins. The first reason is that Wal-Mart appears to be once again sharpening its pricing focus, especially in light of the more challenging economic picture in Canada. For its part Loblaw is getting its pricing format into a better competitive posture compared to recent years. Furthermore, as noted in an October 30 Wall Street Journal article, the days of rapidly rising grocery prices may be nearing an end as supermarkets push back against food companies that are reporting profit increases. The Journal noted that with corn, wheat and other commodity costs coming off their summer peaks and the economy continuing its slide, grocery chains are balking at food makers' efforts to raise prices further.

In fact, some retailers are using food companies' earnings reports as leverage to reject price increases, according to industry analysts. Others are pushing for more promotional allowances -- such as buy-one-get-one-free deals -- to help move higher volumes of goods.

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