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PUBLIC

COMMERCE COMMISSION

Decision No. 448

Determination pursuant to the Commerce Act 1986 in the matter of an application for Clearance involving:

PROGRESSIVE ENTERPRISES LIMITED

and

WOOLWORTHS (NZ) LIMITED

The Commission:	P R Rebstock P J M Taylor D R Bates
Commission Staff:	
Summary of Application:	Progressive Enterprise Limited has sought clearance to acquire all the shares in Woolworths (New Zealand) Limited and/or its immediate holding company Denstree Corporation Limited
Determination:	Pursuant to section 66(3)b of the Commerce Act 1986, the Commission declines to give clearance for the proposed acquisition.
Date of Determination:	14 December 2001

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THE PROPOSAL

1. On 24 October 2001, the Commerce Commission ("the Commission") registered a notice pursuant to section 66(1) of the Commerce Act 1986 ("the Act"), in which clearance was sought by Progressive Enterprises Limited ("Progressive") for the acquisition of all the shares in Woolworths (New Zealand) Limited ("Woolworths") and/or its immediate holding company Denstree Corporation Limited ("Denstree") ("the application").

2. The application follows Progressive's previous application registered on 25 May 2001 (which was determined under the dominance test) and determined by the Commission's Decision No. 438 on 13 July 2001. Subject to divestments, the Commission gave clearance to the proposed acquisition on the basis that it was satisfied the acquisition would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position. Foodstuffs (Auckland) Limited ("Foodstuffs (Auckland) appealed to the High Court and then the Court of Appeal on the basis that the Commission's application of the dominance test to the proposed Progressive/Woolworths acquisition was incorrect. The Court of Appeal held that the Commission should have applied the substantial lessening of competition ("SLC") test. The Commerce (Clearance Validation) Amendment Act 2001 validated all decisions made under the dominance test prior to the transitional amendment except for Decision 438 in relation to Progressive's previous application.

Undertakings

3. Following the registration of Progressive's application, Progressive offered an undertaking that, within twelve months of the completion of the acquisition, it would divest to a person not interconnected or associated with it the following interests:

    ?? All its legal and equitable interest in one of the two properties currently operated as supermarkets (3 Guys or Woolworths) in Te Awamutu, the exact property to be specified to the Commission within two weeks of the acquisition being completed and this undertaking to operate in respect of the property so specified; and

    ?? All its legal and equitable interest as lessee in the land and buildings at 180 Mokoia Road, Birkenhead, which is currently operated as a Foodtown supermarket.

4. Section 69A states:

    Commission may accept undertakings –

    (1) In giving a clearance or granting an authorisation under section 66 or section 67 of this Act, the Commission may accept a written undertaking given by or on behalf of the person who gave notice under section 66(1) or section 67(1) of this Act as the case may be, to dispose of assets or shares specified in the undertaking.

    (2) The Commission shall not accept an undertaking in relation to the giving of a clearance or the granting of an authorisation under section 66 or section 67 of the Act, other than an undertaking given under subsection (1) of this section.

(3) An undertaking given to the Commission under subsection (1) of this section is deemed to form part of the clearance given or the authorisation granted in relation to the acquisition to which the undertaking relates.

5. The Commission is satisfied that the undertaking has been given by, or on behalf of the applicant in this case, and that it relates to the disposal of assets or shares.

Effect of Divestments

6. Progressive has offered divestments in two areas of high concentration (namely, Birkenhead and Te Awamutu). In Decision 438, the Commission accepted these divestments, and took them into consideration when assessing the acquisition of dominance. However, submissions made by Foodstuffs (Auckland) have questioned the effectiveness of the divestments.

7. Foodstuffs (Auckland) submits that:

> "…divestment of an individual store, unless to a meaningful competitor, will not 'cure' any substantial lessening of competition that will otherwise occur in any geographic market."
>
> and
>
> " Any acquirer (other than Foodstuffs) will not have the buying power and influence with suppliers to offer customers competitive grocery prices and provide any form of meaningful competition with the store of the merged entity."

8. Progressive was of the view that the divestments are not necessary to maintain competition in the Birkenhead and Te Awamutu markets. However, in specific response to the above submission from Foodstuffs (Auckland), Progressive argued, *inter alia*:

> "…a reduction of the aggregated concentration must necessarily reduce the market power to an extent. …even if the sites did not continue to be operated as supermarkets, their existing customers would be dispersed to other sites. The merged entity would have to be a monopolist to capture all those customers. In fact, they would be captured by competitors as well, thereby strengthening their competitive position."
>
> and
>
> "…The Commission has previously identified resource consents as the chief barrier to entry… that concern would not exist in the case of Te Awamutu or Birkenhead following divestment. Given that the divestment ensures that a site will be available in both markets for near-immediate entry by a new participant, that entry clearly meets the *lets* test."

9. The Commission accepts that it cannot be certain that the assets to be divested will necessarily be used to compete in the market in the future. That is a possibility with many divestments proffered with business acquisition applications. In this case the Commission recognises that the assets are designed for use as supermarkets (and that in the case of Birkenhead, at least, these consents are not always readily obtainable). It is the Commission's view that post-acquisition it is likely that Foodstuffs would have an

incentive to acquire the stores and operate them as supermarkets, particularly as the alternative would be to see its competitor obtain market power in those regions.

THE PROCEDURES

10. Section 66(3) of the Act requires the Commission either to clear or decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Extensions of time were sought by the Commission and agreed to by Progressive. Accordingly, a decision on the application was required by 14 December 2001.

11. In its application, Progressive sought confidentiality for specific aspects of the application as well as various supporting documents. A confidentiality order was made in respect of the information for a period of 20 working days from the Commission's determination. When that order expires, the provisions of the Official Information Act 1982 will apply.

12. The Commission's determination is based on an investigation conducted by staff. Staff have used information gathered during Decision 438, although new information has been received in the current investigation through consultation with interested parties. The Commission has also received additional submissions and economist reports from Progressive and Foodstuffs (Auckland). Progressive commissioned NZIER to do its economist reports, while Foodstuffs commissioned Charles Rivers Associates ("CRA").

13. The Commission's approach to adjudicating the application is based on principles set out in the Commission's *Practice Note 4*.[1]

THE PARTIES

Progressive Enterprises Limited

14. Progressive is owned by Foodland Associated Limited ("FAL"), a public company incorporated in Western Australia. FAL conducts wholesale and retail supermarket operations in Western Australia and New Zealand. It recently purchased 36 Franklin stores in Queensland and New South Wales. FAL also owns Farmers Holdings Limited ("FHL") which operates Farmers, New Zealand's second largest department store chain. FHL previously operated the Deka chain of department stores, which were recently closed.

15. Progressive's banners include Foodtown (around 30 stores), Countdown (around 32 stores), and 3 Guys (around 6 stores). Foodtown is a full-service supermarket, while both Countdown and 3 Guys are discount stores. Progressive also operates a wholesale grocery distribution conducted through The Supply Chain and Red Arrow. Through its wholesale grocery distribution operation, Progressive supplies the Fresh Choice and SuperValue chains.

[1] Commerce Commission, *Practice Note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

Woolworths (New Zealand) Limited

16. Woolworths and Denstree are owned ultimately by Dairy Farm International Holdings Limited ("Dairy Farm"), a public company listed on the Hong Kong and London stock exchanges. Dairy Farm operates supermarkets, hypermarkets, convenience stores, and drugstores throughout the Asia-Pacific region. Dairy Farm recently sold its Australian supermarket chain Franklins.

17. Woolworths operates the Woolworths, Big Fresh, and Price Chopper groups. There are around 60 Woolworths stores, 11 Big Fresh stores and 14 Price Chopper stores.[2] Woolworths are full-service supermarkets, while Big Fresh is described on Woolworths' website as offering a "wide range of fresh foods, discount groceries and … a large market-style store.". Price Chopper supermarkets are limited-range discount stores located mainly in small towns. Woolworths also has three dry grocery distribution centres, and two meat processing plants.

18. Woolworths has recently formed an alliance with independent petrol retailer Gull Petroleum to operate Woolworths outlets in its 17 service stations located mainly in the Auckland and Bay of Plenty areas. Woolworths has also announced that Price Chopper stores and many Big Fresh stores will be phased out and replaced by the Woolworths banner.

Other Relevant Parties

FreshChoice/SuperValue

19. FreshChoice and SuperValue (together "FCSV") are independent owner-operated supermarkets, based mainly in the South Island. FCSV mainly source their goods through Progressive's distribution centre "The Supply Chain" and Red Arrow tobacco distributors. This arrangement is not an exclusive purchasing arrangement.

20. The FreshChoice banner offers a wide product range and full service, similar in nature to Woolworths and New World. In comparison, SuperValue generally has a smaller range, a lower level of service, and is located in smaller catchment areas. In total there are around 39 stores in the FCSV banner. This comprises seven FreshChoice stores and 32 SuperValue stores. These stores are mainly based in the South Island, although there are three SuperValues in the North Island.

21. In Decision 438 (paragraphs 21-22) the Commission considered whether either FCSV or Progressive had a strong degree of influence over the other, which would imply association. The following points were noted:

    ??[ ];

    ??[ ];

    ??[ ];

    ??[ ];

    ??[ ];

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[2] *See* http://www.woolworths.co.nz/about_us/default.asp, available 11 December 2001.

??[

]; and

??[ ].

22. Having regard to the above factors, the Commission considers Progressive and FCSV to be associated for the purposes of this application.

Foodstuffs

23. There are three separate Foodstuffs companies: Auckland, Wellington and South Island. Each Foodstuffs company is a cooperative, owned by the individual owners of supermarkets within the chain. The three Foodstuffs companies have no overlapping ownership or directorships. They do share ownership of Foodstuffs (New Zealand) Limited ("Foodstuffs (New Zealand"), which is a small company used primarily as a lobby group, and which represents the three cooperatives on industry bodies. Foodstuffs (New Zealand) also owns the banners New World, Pak'N Save, and Four Square and leases those to the three Foodstuffs companies.

24. Each Foodstuffs store operates similarly to a franchise such as McDonalds. The franchise agreement covers store format, product range, pricing, marketing and store fit-out. There is a formal lease document covering the premises and each store pays various levies to Foodstuffs for group advertising, training, and other support services.

25. Foodstuffs operates the banners Pak'N Save, New World, Four Square and Write Price (which is being phased out). Pak'N Save is a discount supermarket banner, which has relatively limited range and service. It is generally acknowledged as having the lowest prices of any banner. Pak'N Save stores have been highly successful since their introduction to the market, and account for twenty of the top thirty supermarkets in New Zealand in terms of turnover. New World offers a greater range and service. Four Square stores are more convenience stores rather than supermarkets and are typically located in small catchment areas.

26. Each Foodstuffs company also operates a cash-and-carry operation. In Auckland this is called James Gilmour & Co Limited, in Wellington, Toops Wholesale Limited, and in the South Island, Trents Wholesale Limited.

MARKET DEFINITION

27. The Act defines a **market** as:

> *. . . a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.*

28. For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-

transitory increase in price, assuming all other terms of sale remain constant (the '*ssnip* test'). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.

29. The Commission seeks to define relevant markets in terms of four characteristics or dimensions:

?? the goods or services supplied and purchased (the product dimension);

?? the level in the production or distribution chain (the functional level);

?? the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and

?? the temporal dimension of the market, if relevant (the timeframe).

30. The Commission seeks to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

Product Dimension

31. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those products on the supply-side.

32. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.[3] The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the *ssnip* test to determine market boundaries. The Commission takes into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

The nature of the product

33. Supermarkets, specialty grocery stores and convenience stores play an important role both in sourcing food and grocery items and in facilitating their supply within populated areas. These outlets do not typically produce the goods they sell but rather provide retail "services" to their customers. While it is true that the physical products they sell are often identical, the services they offer can differ markedly.

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[3] In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission said: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive". See also *News Limited v Australian Rugby Football League Limited &Ors* (1996) ATPR at 41,687, where Burchett J stated: "Long term prospects that can be more or less clearly foreseen are, to that extent, a present reality, from the point of view of identifying the constraints upon commercial action. This fact emphasises the importance of the principle . . . that substitution possibilities in the longer run may be very significant for market delineation." Also *Re Tooth & Co Ltd v Tooheys Ltd* (1979) 39 FLR 1 emphasises longer run substitution possibilities.

34. Service characteristics that can vary between outlets include location, the variety and range of products carried (usually increasing with the size of the store), staff service levels, store ambience, payment options and ancillary services such as car parking. What must be ascertained is those levels or features of these services that delineate a distinct market in which a hypothetical monopolist could profitably impose a *ssnip*. However, the Commission notes that the multiplicity of dimensions by which offerings might vary means that clear-cut boundaries may in practice difficult to draw.

35. The ability of supermarket chains to vary these dimensions of service allows them to compete on grounds other than just price. Such "differentiated" offerings are apparent when distinct mixes of these dimensions, usually encapsulated in a given brand name, are designed to appeal to different consumer groups. Product or service differentiation is often intended to distance a firm from its rivals by reducing substitutability, and so increasing its market power. In extreme cases, the differences can become large enough to put a firm in a different market. A degree of differentiation is evident in supermarkets' various offerings.

The Commission's previous view of the market

36. In Decision No. 438 (paragraphs 32-42) the Commission considered Progressive's view that the market might include competition from non-supermarket outlets, and accepted that "specialist stores and convenience stores do provide competition to segments of supermarkets and for some of their customers", but it was not satisfied at that time that such stores were sufficiently substitutable for supermarkets to preclude supermarkets from imposing a small yet significant and non-transitory increase in price.

37. Notwithstanding its expressed view, Progressive conceded at that time that the application should proceed under what it considered to be "the conservative approach … on the basis that if a clearance is justified on the narrow definition then it must be justified on the broader" (where the conservative approach was to consider the markets as only comprising supermarkets). In the current application, Progressive challenged that approach.

Progressive's proposed market

38. Progressive has proposed a market definition that includes supermarkets and other retail outlets that sell products commonly offered in a supermarket. It is argued that such a market definition, "emphasises the products purchased, not the place purchases are made". It is submitted, on this basis, that supermarkets participate in multiple product markets which might be grouped along the following lines:

    ?? Meat, deli and seafood

    ?? Bakery products

    ?? Fresh fruit, vegetables and flowers

    ?? Beer and wine

    ?? Frozen goods

    ?? Dry groceries

    ?? Dairy products

?? General merchandise

?? Health and beauty products

39. Considered from this perspective it would seem that supermarkets face competition from any outlet that provides these products. For instance, a supermarket's fruit and vegetable department would face competition from not only the like department of a rival supermarket, but also from specialist greengrocers. The application notes that, "supermarkets do not appear to have a monopoly on supply of any product type".

40. Were this definition of the market to be adopted as correct, supermarkets would be held in check by, not only other supermarkets, but also by a broad range of other outlets such as specialist retailers and convenience stores.

The Commission's view of the appropriate market

41. The Commission has considered Progressive's arguments regarding the market but remains of the view that specialist and convenience stores may provide limited constraint on supermarkets. In reaching this view, the Commission gives particular weight to the following two factors: 1) transaction costs, and 2) the current practice of supermarket chains.

Transaction costs

42. The application describes the results of an exercise whereby Progressive found that a basket of goods bought from a number of specialist shops was slightly cheaper than the same basket purchased from a supermarket. Research conducted by CM Research, and provided by Progressive, asked respondents who do not make their *main* meat, produce or bakery purchases at a supermarket despite already shopping there, why they do this. Price was the main reason given for meat (indicated by 47-55%) and produce (62-77%). Confirming this, management from meat and produce specialty chains spoken to by Commission staff indicated that low price was one of their main advantages.

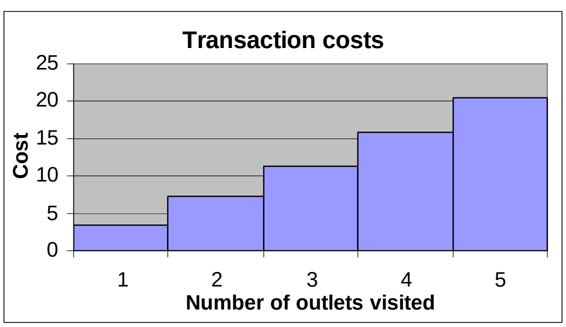
43. The evidence suggests that supermarkets are not necessarily the cheapest way to buy groceries and that a determined shopper may purchase their groceries more cheaply by shopping around. This raises the question as to how supermarkets provide value to consumers and how they are able to secure significant market share in so many of the categories in which they trade. The Commission concludes that the answer is in the economies of scope enjoyed by the supermarket shopper. Such economies of scope would manifest themselves in a reduction in the number of purchase transactions, and in the concomitant fixed costs of these transactions, by the potential to "one-stop-shop" at a supermarket.

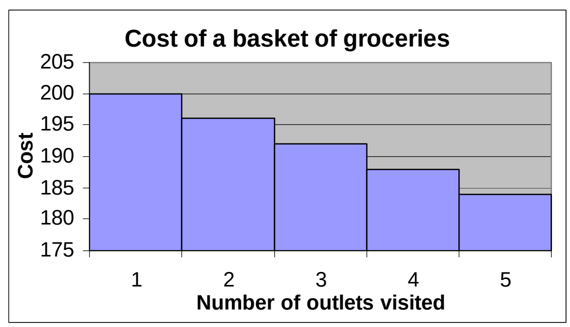
44. Such transaction costs are expenses incurred by the shopper in addition to the shelf price of products, and include eftpos bank fees, transportation costs, search costs (costs in gaining information regarding which store sells a given product or basket most cheaply[4]) and, perhaps most importantly, the "opportunity cost" of time. The "opportunity cost" of an action or activity is defined as, "the value of the best forgone alternative use of the

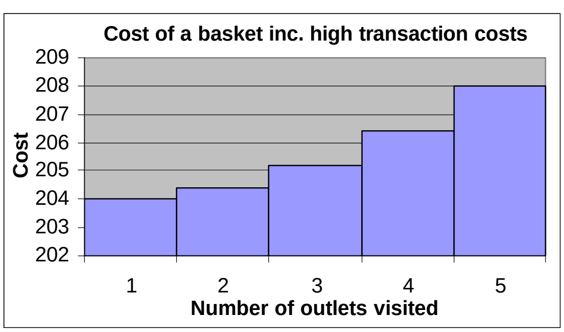
[4] Search costs are generally considered more significant for consumers who are in the area for a short duration – see *Modern Industrial Organization*, D. W. Carlton and J. M Perloff, 1994, pp 568. Given that stores' relative prices change little, this "investment" need only be made once, or infrequently, and so for consumers that are shopping in the area regularly over a longer timeframe the search costs per shopping trip are low.

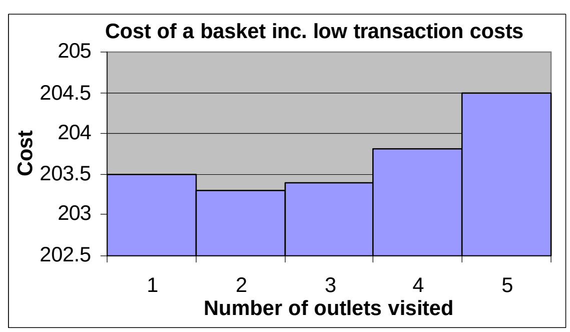
resources employed in that action"[5]. A shopper's opportunity cost of time is the value, to the shopper, of what he or she could be doing with the time if not shopping. The opportunity cost of time will vary between shoppers. Although its real value is subjective, it can be assessed objectively by reference to factors such as the shopper's wage rate. A simple intuitive gauge of a shopper's opportunity cost is how busy the shopper is with things other than shopping. If, for instance, the shopper has full-time employment, studies part-time and has young children then he or she will likely have a high opportunity cost of time.

45. The trade-offs of shopping around against buying the entire basket at one place are best illustrated with an example. The numbers used have been chosen to be illustrative rather than representative. A shopper incurs fixed transaction costs (see graph – "Transaction costs") for each outlet visited – these do not vary with the amount bought at an outlet although they may vary with the outlet depending on such things as the availability of parking and the length of checkout queues. However, the shopper will also save a certain amount by shopping around – the more outlets visited the more will be saved (see graph – "Cost of a basket of groceries"). There will be some number of outlets visited by the shopper where the sum of the cost of the goods in the entire basket and the total transaction costs is minimised. The best number of outlets for a shopper to visit will depend on that shopper's individual transaction costs. The graph "Cost of a basket inc. high transaction costs" shows that total costs are minimised by shopping at one outlet only. The graph "Cost of a basket inc. low transaction costs" shows that transaction costs as minimised by shopping at two outlets. The presence of significant transactions costs leads to the conclusion that a rational (cost minimising) shopper is likely to shop for food and groceries at only a very few outlets per week.









46. CM Research Customer Survey results provided by Progressive show respondents' ranking of features that are considered important when choosing a supermarket. Price

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[5] *Abid.*

ranks between third (equal) and fifth in importance depending on the city. Location, parking and range are all more highly ranked (for Christchurch price and range rank third equal) in all cities for which the statistic is provided. All these features can be linked with the transaction costs of a shopping trip. According to other results from CM Research, for the shoppers that carry out their meat or produce shopping away from a supermarket (a minority) the primary reason is price (47-77%). Transaction cost features, such as range (9-31%) and convenience (7-15%), are much less significant. These results together support the argument that the trade-off between prices and transactions costs illustrated above is influencing consumers' current purchasing patterns.

47. The above example highlights that unless a shopper has low enough transaction costs that visits are made to all outlets necessary to get the cheapest basket (on shelf price), he or she will be faced with purchasing from a supermarket some goods that might have been bought elsewhere for a lower shelf price. At this point the shopper faces a discrete all up cost of visiting another outlet. This cost to the shopper of substituting to another outlet is likely to enable a hypothetical monopoly supermarket to charge a *ssnip* above competitive prices (ie cheapest shelf prices) without significant numbers of customers switching.

Current supermarket practice

48. Progressive's stated view of the market seems to be at odds with its own practice and that of supermarkets generally. Staff from all three supermarket chains described systematic, thorough and quite sophisticated procedures for the monitoring and analysis of rival supermarkets' prices. Typically, individual lines are grouped into three or four categories. The top category (key lines) of approximately 150[6] lines is checked against those of competitors on a weekly basis, the next category fortnightly, and so on. Over a full cycle of six or eight weeks, thousands of lines have been processed in this way. The Commission regards it as significant that these procedures are directed almost entirely toward other supermarkets.

49. In a subsequent submission (13 November 2001) Progressive took the opportunity to elaborate on the extent of its competitive monitoring and response toward non-supermarket outlets. In the submission it was noted that, "{b}ecause Foodstuffs also operates in the fast-moving-consumer-goods ("FMCG") market and must have regard to non-supermarket competition as much as Progressive does, then for all these reasons it is generally sufficient for our purposes if Progressive primarily keeps an eye on Foodstuffs prices, subject to exceptions where required." The Commission finds this, rather circular, logic generally insufficient to show competition with non-supermarket outlets.

50. The 13 November submission details where and how Progressive monitors and responds specifically to non-supermarket outlets. This tends to confirm the general impression that, while some competition does seem to take place with such outlets, it is the exception, rather than the usual mode of operation. In addition, the nature of price-checking of non-supermarket outlets is neither as frequent nor as thorough as is carried out against other supermarket chains. The other supermarket chains confirmed that they also reacted to specialists' prices but that this was by exception rather than the rule.

51. In *Re QCMA and Defiance Holdings* (1976) A.T.P.R. 40-102 a market is explained as "the area of close competition between firms". Such close competition is evident between

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[6] The lines so checked exclude variants such as all flavours in the case of sachet fruit drinks. This means that the number of actual stock keeping units (SKUs) checked is greater.

supermarkets but not toward other store types. The Commission finds that supermarkets are, in general, primarily concerned about competition from other supermarkets and not other outlets.

Top-up shopping

52. Findings in other jurisdictions,[7] and Progressive's own research results, confirm that it is common practice among shoppers to conduct a large, regular shopping trip for groceries on a weekly or fortnightly basis and to supplement such trips with smaller "top-up" shops done as items bought in the main shop are consumed. Commission staff initially surmised that top-up shopping at supermarkets might have close substitutes in non-supermarket outlets and, so, fall outside the market. However, there appears to be scant research concerning this type of shopping in New Zealand.

53. A United Kingdom study[8] on supermarkets does consider this issue in some detail, and the Commission considers that this is likely to provide a reasonable proxy for the New Zealand situation. The study found that, though less pronounced than for the main shop,[9] the supermarket was still used by a clear majority of respondents for top-up shops in all grocery categories. Information from Progressive showing the average size of purchase transaction to be quite small seems to confirm this and it is likely that, even for top-up shops, consumers require a range of items. In any event, it would seem that supermarkets seek to scale the transaction costs for such shoppers by such methods as express lanes and the availability of express baskets or bags. In conclusion, the Commission considers that a significant number of consumers are not likely to substitute away from supermarkets even for the top-up shop were supermarkets to impose a collective *ssnip*.

Separate full service and discount supermarket markets

54. The Charles River Associates report included in Foodstuffs' submission proposed that supermarkets might fall into two separate markets being full service (New World, Woolworths, Big Fresh and Foodtown) and discount (Pak' N Save and Countdown). Commission staff found that the supermarket chains are at pains to establish and maintain clearly delineated market positions for their various banners, and there is anecdotal evidence that some consumers might indeed regard offerings in different market positions as poor substitutes.

55. However, Commission staff also found that respective supermarket banners do not clearly fall into one of two distinct groupings, but are more accurately described as being distributed along a service-price continuum. The chains seem to prefer to position their banners on this continuum in order to establish a point of difference from their competitors. This is evident in the ability of different supermarket banners to operate at differing average price levels, with premiums of up to 10%[10] being charged, in part reflecting differences in quality of service. It is the view of the Commission that this is consistent with a single, differentiated service market rather than two separate markets.

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[7] See *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom,* July 2000, Competition Commission and *re Queensland Independent Wholesalers Ltd* (1995) A.T.P.R. 41-438

[8] Ibid.

[9] The UK Competition Commission's report found that, "although the main supermarkets featured strongly in top-up shopping patterns, there was greater use of alternative grocery outlets for top-up shopping".

[10] *Consumer*, June 2001

Convenience stores

56. Convenience stores consist of the likes of corner dairies and larger service stations, and include banners such as Four Square and StarMart.

57. Submissions from both Progressive and Foodstuffs have generally arrayed convenience stores with specialty stores in their respective arguments but they do differ significantly. The CM Research results cited at paragraph 46 indicates that consumers primarily shop at specialty stores because they are cheaper than supermarkets. By contrast it seems that convenience stores are significantly more expensive than supermarkets.[11]

58. As noted in Decision 438 (paragraph 40) the distinction between a small supermarket and a large convenience store may not be clear. This reflects the fact that convenience stores share a continuum with supermarkets, based on floor size and number of lines, in the non-specialist sale of groceries.

59. However, in general, the difference in price between them is such[12] that consumers using a supermarket for their main regular shop are unlikely to substitute to convenience stores in the event of a collective *ssnip* by supermarkets. In addition, current patterns of consumers purchasing in convenience stores are quite different to those of supermarkets in that purchases tend to be in a narrower range of fast moving items. According to Foodstuffs (Wellington) tobacco products, softdrinks / confectionary and milk / bread comprise the main lines for this type of store. It is most likely that convenience stores' mode of operation is to serve demand for smaller purchases, including small top-up shops and items for immediate consumption, at a convenient location.

View of the appropriate market in other jurisdictions

60. In 1999 the Competition Commission in the United Kingdom was asked to investigate and report on the supply of groceries from supermarkets amid concerns that consumers were paying higher prices than their counterparts in other countries. Chapter 4 in its resulting report[13] considers what should be an appropriate market definition. It notes that "{s}everal of the main parties suggested that there were a series of partial economic substitutes to the basket of products purchased at supermarkets when viewed at the individual product or category level".

61. The Competition Commission carried out a survey which found that:

> "The main factor and most likely influential determinant of store choice is the ability to one-stop shop. Seven in ten regarded it as an important factor and it was considered the primary reason of store choice by more than twice the proportion of any other factor."

When respondents were asked to name their next best choice of store to the one they currently used, 78% named a supermarket, 5% named a limited range discounter while specialist and convenience stores were each chosen by 1%.

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[11] See pp 10 of the Charles River report.

[12] The Foodstuffs submission pointed to A C Neilsen research which found that a basket representing a major FMCG shopping trip (not including meat) was 49% more expensive at StarMart than at Pak'N Save. These stores probably represent either end of the non-specialised grocery outlet spectrum.

[13] *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, July 2000, Competition Commission

62. The Competition Commission concluded that "the relevant economic market for the purposes of our investigation is the market for one-stop grocery shopping carried out in stores of 1,400 sq metres or more", which suggests that specialist and convenience stores were not in the same market as supermarkets.

63. In *re Queensland Independent Wholesalers Ltd* (1995) A.T.P.R. 41-438 the Australian Trade Practice Tribunal looked at the wholesale and retail distribution of groceries in the context of a merger between vertically integrated wholesalers. In considering specialist food suppliers (fruiterers, butchers, delicatessens, bakeries and gourmet stores) and food service retailers (restaurants and takeaway outlets) it decided that they were on "the 'outer boundaries' of that market, rather than within it"[14]. The Tribunal also found that, due to increasing mobility and longer shopping hours, supermarkets had become substitutes to convenience stores, but there was no suggestion that the converse was true.

64. While not relating to supermarkets, in *Dowling v Dalgety Australia Limited & Ors* (1992) A.T.P.R. 41-165 the Court considered whether products that were jointly supplied in a distinctive manner could comprise a market separate from other firms that provided the products individually. The Court's conclusion was that such a separate and distinct market in "supplying packages of related services" did exist.

65. In conclusion, the Australian and United Kingdom jurisdictions adopt a separate supermarkets market definition.

Product market conclusion

66. Practice note 4 on the subject of product market definition notes that:

> "On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers." (p 17)

In the current case, a basket of goods from a supermarket is nominally substitutable for a basket of goods from a number of other outlets, but the additional transaction costs involved mean that buyers are unlikely to regard the other outlets collectively as a substitute to a supermarket.

67. The Act requires that a market is defined according to "commercial common sense". The day to day business of operating a supermarket chain has its management competing with other supermarket chains, and largely ignoring the responses of other food and grocery shops.

68. The Commission considers that the product market is a supermarket market. This market involves the provision of a retail service, whereby consumers may purchase a wide range of groceries at low or moderate cost in a single purchase transaction. Such a service enables consumers to purchase a basket of groceries at minimum cost taking into account shelf prices and transaction costs. The service so offered under different banners is likely to be differentiated to some degree. It is in a market thus defined that a monopolist supermarket could profitably impose a *ssnip*. This is unchanged from the view of the

[14] *Market definition: Competition law and practice*, 1998, M. Algie, B Kewley

Commission in Decision 438, that specialist and convenience stores should be excluded from the market and that the relevant market should comprise all stores trading under the names of Foodtown, Countdown, 3 Guys, FreshChoice, SuperValue, Woolworths, Big Fresh, Price Chopper, Pak'N Save, New World, and Write Price.

The Geographic Dimensions of the Market

69. In its assessment of the earlier application, the Commission considered that it was appropriate to use geographic markets of around 5 km in radius when analysing the competitive impact of the proposed acquisition. The Commission recognised, however, that there is not a uniform size of market that applies to all areas; rather, there is a range of small sizes that reflect a variety of factors influencing how far consumers will be willing to travel to an alternative supermarket if faced with a small but significant price increase. These factors include the presence of physical barriers to travel, the density of traffic on the roads and the levels of car ownership.

70. In reaching the 5 km radius as an approximate guide, the Commission took into account the views of the various supermarket chains and other retailers, the distance commonly travelled by shoppers to reach supermarkets, and also the theoretical model produced by NZIER for Progressive based on the cost of travel, the size of customers shopping basket, the ratio of fixed and variable costs, and other factors.

71. Commission staff sought the views of the interested parties on the appropriateness of the 5 km figure during its investigation of the current application. The common view of all of the parties was that 5 km was about right as a general guide. It also appears reasonably consistent with the geographic market used in other countries. The parties spoken to, and the Commission, recognise that there can be features in particular areas which could make another figure appropriate in those areas.

The Wholesale Supply of Groceries

72. Consideration of the proposed acquisition requires an assessment of the market power that would be held by buyers in the grocery wholesale market. The Commission considers that this can be undertaken most effectively in the context of a national market. Most suppliers supply nationally and there do not appear to be important differences in the way the market operates in different parts of the country.

Conclusion on Market Definition

73. The Commission concludes that the relevant markets for the consideration of the application are:

    ?? the market for the retailing of grocery items in supermarkets, incorporating regional markets not less than 5 km in radius; and
    ?? the national market for the wholesale supply of groceries.

COMPETITION ANALYSIS PRINCIPLES

Substantially Lessening Competition

74. Section 47 of the Act prohibits particular business acquisitions. It provides that:

> A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.

75. Section 2(1A) provides that substantial means "real or of substance". It is a question of degree.[15] The lessening needs to be of such size, character and importance to make it worthy of consideration.[16]

76. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.[17]

77. While the Act defines the words "substantial" and "lessening" individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess:

- ??the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);
- ??the nature and extent of the contemplated lessening; and
- ??whether the contemplated lessening is substantial.[18]

78. In interpreting the phrase "substantially lessening competition", the Commission will take into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

> Two of the three key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.

and, in relation to s47:

> This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).

79. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the

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[15] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20). For further discussion see Gault on Commercial Law at CA 27.14.

[16] *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [ ] 1 All ER 289.

[17] For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

[18] See *Dandy*, supra n 5, pp 43–887 to 43-888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [ ] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [ ] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through coordination between firms.

80. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

The Change in the Threshold

81. Progressive has submitted that the new substantial lessening of competition test for business acquisitions represents a broadening of the merger test rather than a general lowering of the threshold. It has further suggested that the acceptable level of market power arising from an acquisition is unchanged.

82. The Commission accepts Progressive's submission that the new test is a broader test than previously. As Progressive noted, the Commission is required to have regard to such matters as the potential market power arising because of the differentiated nature of the market, the prospect of coordinated conduct and the elimination of a particularly vigorous or effective competitor.

83. The Commission does not accept Progressive's submission that the market power threshold is unchanged with the change in the Act.

84. The Commission has given careful consideration to the wording of the amended Act and the expressed intentions when the new legislation was before Parliament. It has come to the clear view that the threshold is different. There is a level of market power which was acceptable in the past but which is no longer so.

The New Threshold

85. The factors relevant to each market are different, and the Commission does not believe that one numerical test of dominance, or of substantial lessening of competition, can be applied across all markets. The Commission recognises that it is generally impossible to be precise in its calculation of existing levels of market power, let alone to foresee with a high level of accuracy what additional market power might arise in the future because of an acquisition. Further it recognises that it is not always possible to measure changes in market power by focussing on one indicator (such as possible price increases) alone.

86. Nevertheless, the Commission believes that it may be helpful for it to provide a numerical indication (albeit one with many caveats) of how it views the change.

87. As a general guide, and recognising that this guide will not be applicable in all circumstances, the Commission considers that an increase in market power which would be likely to lead to a 4%-5% price increase (or reduction in conditions which was the equivalent of 4%-5% price increase) would suggest a substantial lessening of competition. The supermarket sector is one in which the Commission considers that it may be appropriate to apply a lower threshold. This is discussed further below.

88. Prior to the change in the Act, the Commission had considered (again with many caveats) that a firm in a dominant position in a market was one which was in a position to increase prices above competitive levels by in the order of 5%-10%.

The Counterfactual

89. The Commission uses a forward-looking, counterfactual, type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

90. The present state of competition in a market can be referred to, in order to illuminate the future state of the market where there is a range of possible scenarios should the merger not proceed.[19]

91. The Commission has seen nothing to suggest that the present business of Woolworths will not be viable in the forseeable future. Accordingly, the Commission has adopted the status quo, with Woolworths – whether under current or changed ownership – continuing to operate as an independent player in the market, as the counterfactual.

Potential Sources of Market Power

92. Two types of market situation conducive to the exercise of substantial unilateral market power are now considered. These involve making the distinction between undifferentiated and differentiated product markets. That distinction may also have a bearing on the scope for coordinated behaviour in a market.

93. In undifferentiated product markets, where buyers make their purchases largely on the basis of price, and the production capacities of firms are an important element in competition, a business acquisition may have the potential to substantially lessen competition when the combined entity has acquired a market share below that required for dominance. This is especially likely in circumstances where the rivals of the combined entity cannot easily expand production to offset its output contraction within a one year time frame.[20] The inability of rivals to expand may result either from their facing binding capacity constraints, or because additional capacity is significantly more expensive to operate.

94. In differentiated products markets, where the product offerings of different firms vary, and in which buyers make their purchase decisions on the basis of product characteristics as well as of price, the products of firms are by definition not perfect substitutes for each other. The substitutability between products will vary depending upon differences in their various characteristics, which may include their physical specifications, brand

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[19] *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* (2000) ATPR 41 at paras 113 & 114.

[20] See, for example, Roger D Blair and Amanda K Esquibel, *The Roles of Areeda, Turner and Economic Theory in Measuring Monopoly Power* (1996) Antitrust Bulletin, 781, especially pp 791-95.

image, associated services and location of sale. In simple terms, differentiated products can be thought of as being arranged in a "chain of substitutes", where those in adjacent positions in the chain tend to be close substitutes, and those positioned further apart are less close substitutes.

95. The supply-side characteristics of differentiated products markets are important, as the potential market power of the combined entity may be offset by the actions of rivals. However, rivals may not be able to offer a competitive constraint where they are unable either to re-position their products closer to that of the combined entity to replace the lost localised competition, or to strengthen the promotion of existing products. A further possible constraint would be lost if it were not possible for new products to be added through new entry.

96. The level of differentiation in a market also has implications for the potential for coordinated market power. Collusion (whether explicit or tacit) is more likely when the product has low levels of differentiation. This is because when a product is standardised it is easier to come to an agreement on price.

Conclusion – Competition Analysis Principles

97. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the status quo. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to coordinate their behaviour so as to exercise such power.

ANALYSIS OF EXISTING COMPETITION FOR RETAIL GROCERY MARKET

Introduction

98. As with Decision 438, the Commission faced the general problem of how to deal with the large number of geographic markets, in which market shares (among other things) vary considerably. For example:

?? on a national basis, the merged entity would have around 45% market share, with the balance made up by the three Foodstuffs companies;

?? on a regional basis, Foodstuffs (Wellington) and Foodstuffs (South Island) is understood to have slightly more than 55% market share, while Foodstuffs (Auckland) has slightly less; and

?? at a local level, the variation in market share range from geographic markets where the merged entity will have no presence, to those in which it will have the only store.

99. It would be impractical to examine every market in detail. In Decision 438 this process was streamlined by focusing on the areas in which high market aggregation would occur. It was assumed that in other areas where there would be low (or no) aggregation,

dominance would not be acquired or strengthened. For the current application, it is not quite so straightforward. The Commission must take account of oligopolistic market structures and outcomes (which can imply concerns with a lower market share than under dominance), and raise the potential for coordinated behaviour (which could be orchestrated at a local, regional, or national level).

100. To deal with the above difficulties the analysis of existing competition will proceed as follows: first, the potential for unilateral power will be considered using oligopoly theory. The Commission has not considered all geographic markets, but has assessed the national ‘average’ market, and those local markets with the highest aggregation that it believes are most likely to be susceptible to price rises. This is used to establish a range in which the outcomes in intermediate markets are likely to fall (that is, those markets with lesser market share than those surveyed). Secondly, the Commission has considered the potential for coordinated market power. The Commission is of the view that if coordinated market power were to occur, it would most likely be facilitated at head office level. In this case, it is not necessary to assess each geographic market separately, since many would be expected to be affected.

101. An important consideration is that because of the wording of s 47, there need only be a substantial lessening of competition in one market for the application to be declined.

Existing Participants

102. The following are the existing participants in the market:

?? Progressive Enterprises (including FreshChoice and SuperValue)

?? Woolworths

?? Foodstuffs (Auckland)

?? Foodstuffs (Wellington)

?? Foodstuffs (South Island)

Inter-firm Relationships

103. Companies that are part of the same corporate grouping, or that have similar strong relationships, cannot be relied upon to provide an effective competitive constraint to one another. Other less formal relationships between companies may also give rise to limitations on the extent of rivalry between them. Relationships between persons in the relevant market and other businesses may also affect rivalry in a market.

104. Fresh Choice/Super Value are supplied through Progressive’s wholesale operation “The Supply Chain”. In Decision 438 (paragraph 21), the Commission found that sufficient links existed between Progressive and Fresh Choice and Super Value to consider them associated for the purposes of analysing the acquisition. This approach will also be adopted for the current application.

105. The three Foodstuffs companies are not legally interconnected or associated. However, there is a level of cooperation between the three firms, which extends to joint venture purchases for overseas products and house brands. However, it would appear that the three firms compete at the wholesale level when purchasing from suppliers. At the

retail level, the three companies do not compete as they each operate in quite separate regions. Each Foodstuffs company holds the rights to the banner names in their respective areas. This precludes (say) Foodstuffs (Wellington) opening a Pak'N Save in Auckland.

106. The Foodstuffs companies are cooperatives whose members are the owner/operators of each store. The head office of each Foodstuffs' company sets the recommended prices for its members as well as organises regional specials. Each store is obliged to comply with prices for regional specials, while for other products it can either implement the recommended price or apply a lower price. Owner/operators also have the flexibility to organise their own specials and introduce their own lines of products at their discretion. This flexibility has given rise to situations where two supermarkets that are both within the Foodstuffs' cooperative appear to compete with each other. The Commission has given consideration to the extent of the competition between individual Foodstuffs stores. Its enquires have revealed that:

?? Instances where there is significant overlap of catchment between Foodstuffs supermarkets are rare. Foodstuffs (South Island) advised that it seeks to position supermarkets so as not to upset operators, although the over-riding goal is to get the best sites. In those instances where there is significant overlap, there are normally different style formats operated (New World and Pak'N Save) which appeal to different types of customers.

?? Most stores' prices are at levels recommended by the cooperative. The proportion of prices set at the store level is relatively low. And there is evidence to suggest a reasonably high level of control from Foodstuffs. The cooperative retains ownership of the land (or holds the head lease) and selects the owner/operator for each store. It also has the ability to remove "rogue" operators who do not perform, or do not conform to the cooperatives overall goals.

?? Virtually all purchasing is done centrally through the cooperative, and for all central purchases the terms to each member are identical. There are exceptions to this rule, particularly for the acquisition of fresh produce in isolated areas (such as Greymouth and Invercargill), but in general, all owner/operators have the same purchasing opportunities as the others.

107. On the basis of the preceding discussion, the Commission has reached the view that although separate Foodstuffs stores may compete to some extent in some areas, it is not to such a degree that they should be considered separate entities for the purposes of a competition analysis.[21]

Market Share of Participants

108. An examination of concentration in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered, as does

[21] Similarly, the managers of a Countdown and Foodtown that are adjacent to each other, may have salary incentives that conflict with Progressives overall goals. In these instances, the individual managers may consider themselves to be "competing with each" but the ultimate control comes from the chain rather than at a store level. The Commission would not consider them to be separate entities.

the nature of the product and the interactions between firms. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market.

Safe Harbours

109. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission's 'safe harbours' can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

- ?? where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or

- ?? where the three-firm concentration ratio (with individual firms' market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.

110. As noted below, market shares by themselves are insufficient to establish whether competition in a market has been lessened. It is the interplay between a number of competition factors, of which seller concentration is only one, that has to be assessed in determining the impact of a business acquisition on competition. In the present case, the oligopolistic features of the market must be considered. It has been recognised that the supermarket market is differentiated in terms of service, and spatially, which justifies the use of a differentiated-products oligopoly model. Market shares are consequently less useful than those in undifferentiated product markets. Instead, it is the diversion ratios[22] between supermarkets that are most important. Other competition factors include entry conditions; the presence of an aggressive, innovative or maverick firm; countervailing power of buyers or suppliers; rapid innovation in the market; and others. These are considered for the relevant market in subsequent sections.

Market Share

111. Markets with the highest aggregation (as assessed in Decision 438, see paragraphs 116-193) are shown in Table 1.

[22] The diversion ratio measures the fraction of sales lost by the acquiring firm that would be captured by the target firm, if the acquiring firm were to raise its prices. A fuller description is contained within the consideration of "Scope for the Exercise of Unilateral Power".

Table 1:

Estimated Market Shares in Selected Areas Post-Merger and Proposed Divestments

	Market Shares*		
Area	**Merged Entity**	**Divestment**	**Foodstuffs**
National average	45		55
Te Awamutu	[ ]	[ ][23]	0
North Shore Auckland	[ ]	[ ]	[ ]
West Auckland	[ ]		[ ]
Nelson/Stoke/Richmond	[ ]		[ ]
Tauranga/Mt Maunganui	[ ]		[ ]

*Market shares based on sales turnover. Data provided by the market participants.

112. All the local markets shown in Table 1 fall outside both safe harbours, as does the national average. These areas have the highest levels of aggregation. They can therefore, be considered the most sensitive in terms of oligopoly analysis, and can be expected to potentially yield the highest post-merger price rises. A fuller description on the characteristics of these markets can be found in Decision 438 (paragraphs 116-193).

Degree of differentiation in the Market

113. It would appear that services provided by supermarkets are differentiated in two different ways: by location (spatially), and by the combined price and quality of the service. This means that no two supermarkets are likely to be perfect substitutes in the eyes of a given consumer. Each consumer is likely to have a preference of one over another because of locational convenience (which surveys have shown to be an important factor in shoppers' choice of supermarket) and because one price/quality 'package' is preferred over another. This in turn suggests that individual supermarkets are likely to possess a degree of market power—they can raise price a little above marginal cost and still retain a substantial proportion of their customers—although this is likely to be limited by the presence of other stores offering close substitute services.

114. Behaviour in such marketsis often analysed by economists using models of imperfect competition, in which consumers view each firm's product as having a particular location in geographic and/or product (characteristic) space.[24] The closer two products in this space are, the more substitutable are they regarded by consumers; the less close, the less substitutable they are. Spatial models predict that competitors will seek to move away from each in the spectrum, in order to create a degree of market power. The degree of market power a firm has will depend on the distance it is away from the next nearest

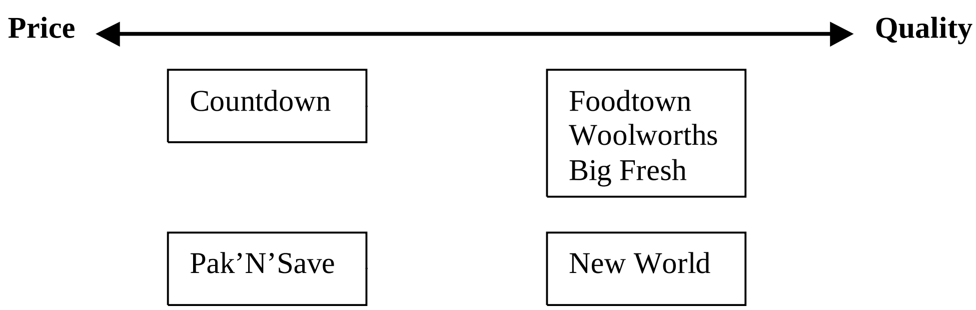
[23] Assumes the 3 Guys store in Te Awamutu is divested.
[24] Dennis W Carlton and Jeffrey M. Perloff, *Modern Industrial Organisation* (3rd ed.), Addision-Wesley, 2000, p. 215.

products, and the extent to which supply-side substitution (product re-positioning to exploit 'gaps' between existing substitutes) can occur.

115. A feature of differentiated products is that markets boundaries can be difficult to delineate: an overly narrowly defined market may exclude significant substitutes; on the other hand, an overly broadly defined market may overlook the differing degrees of constraint offered by close and less close substitutes.

116. The differentiation of supermarkets on the price/quality spectrum is illustrated in a stylised way in Figure 1, which is a simplified view of the current positioning of the main banners in the market. It shows that Pak'N Save and Countdown are positioned as discounters at one end of the spectrum, while Foodtown, Woolworths and New World are positioned as full-service banners towards the other end. The dotted line also indicates the ownership links of the supermarkets that would apply post-merger.

Figure 1: Price/service Spectrum



117. However, Figure 1 over-simplifies the situation, since in reality the firms are more dispersed along the spectrum. Moreover, it seems that some re-positioning has occurred over time. For example, Countdown now packs groceries for customers, which would be seen as movement to the right in the above illustration, while Big Fresh is understood to have moved left on the spectrum since its initial inception, becoming more price competitive. In addition, the figure above uses "quality" to denote many characteristics that consumers will consider when making their decision over choice of store, including service, location, product range, and brand image. Therefore, a multi-dimensional spectrum might be more appropriate.

Conclusion on Differentiation

118. The Commission recognises that the market is spatially differentiated, and in terms of price/service.

Pricing Behaviour of Supermarkets

119. In Decision 438 (paragraphs 108-111), the Commission noted that in setting prices market participants were restricted to a degree by certain pricing practicalities. For example, it would be impractical for a national chain to set prices on a store-by-store basis. Aside from the resources it would require, the chain also risks damaging its reputation if it were perceived as being high cost in any area, and limits its advertising options (that is, it could no longer advertise regionally). There was some evidence

suggesting that supermarkets that operate in isolated areas did not price significantly differently from supermarkets in more competitive areas.

Pricing Policies

120. The following information on pricing policies has been obtained by the Commission:

<u>Foodstuffs (Auckland)</u>

121. Foodstuffs (Auckland) advised that for its New World stores, [ ]

122. Foodstuffs (Auckland) has advised that it has [ ]

123. Pak'N Save stores have recommended prices set for their goods. Owner/operators of the stores may choose to meet the recommend prices, or price lower. They may not price above the recommended prices. Foodstuffs (Auckland) carries out surveys to assess the relative pricing levels between its Pak'N Save stores. It uses these surveys to rank its stores from most aggressive (that is, lowest prices) to least aggressive. Its surveys have revealed:

?? that the lowest ranked (or least aggressive) store this year is [ ];

?? the highest ranked store is normally [ ], where very strong competition would appear to exist; and

?? the difference in average shelf prices between the most and least aggressive stores is in the order of [ ]. It is noted that the spread of prices is exaggerated by [ ], which is (on average) more expensive than the next lowest ranked supermarket by [ ].

<u>Foodstuffs (Wellington)</u>

124. Foodstuffs (Wellington) seems to have [ ] It monitors its rivals' stores very closely and adjusts prices as required. It aims to ensure New World is no more than [ ] above Pak'N Save.

<u>Foodstuffs (South Island)</u>

125. Foodstuffs (South Island) operates [ ] Foodstuffs (South Island) has advised that there is [ ]

126. [ ]

Woolworths

127. Woolworths [

]

Progressive

128. [

]

129. [

]

Conclusions

130. It can be seen from the pricing strategies that supermarkets have the ability to adjust prices to suit local competition. There would appear to be some limits to flexibility, due to the administrative difficulties in operating too many price zones.

Scope for the Exercise of Unilateral Power

Introduction

131. In Decision 438 the Commission found that the acquisition of Woolworths by Progressive would not result in dominance being acquired or strengthened in any of the local markets. The two firms remaining post-merger would both be well resourced and would not appear to be capacity constrained. Therefore, it was unlikely that the merged entity would gain unilateral power in the sense of that considered under the dominance threshold, because it would be constrained by a powerful adversary in the form of Foodstuffs.

132. Under the new substantial lessening of competition threshold, the focus of the competition analysis must take into account the oligopoly structure of the market in question. In such markets, economic theory suggests that even where firms do not coordinate their behaviour, but instead seek independently to maximise their profits, it is possible for unilateral market power to emerge. In addition, a merger in such a market, which in the present case would result in a reduction in the number of firms from three to two, may result in an increase in that market power.

A Pricing Model

133. Given the oligopolistic nature of local markets in this case, and the differentiated nature of the services provided, as discussed above, an appropriate model to test whether unilateral market power might be enhanced as a consequence of the merger is the Bertrand model. This model also has the advantage that it is a price-setting one, in which firms set their prices and allow the market to determine volume of sales, as supermarkets

appear to do. The model assumes non-cooperative oligopoly (i.e., firms 'compete' rather than collude), and that each firm independently chooses its own profit-maximising price on the basis that all other firms hold their prices constant. Although this behavioural assumption is unrealistic, in the sense that firms expectations of others' pricing behaviour is shown in practice to be incorrect, it does generate a market pricing equilibrium which may in some cases at least reflect actual market outcomes.

134. Broadly, the model predicts that product differentiation allows firms to exert market power, and that mergers between significant firms are likely to allow the merged entity (and to a lesser extent other firms) to raise prices. The essential reason why this model predicts that market power may be enhanced by a merger in a differentiated products market is the loss of the competition between the merging brands. Suppose firm A acquires firm B. Previously, it may have been unprofitable for firm A to increase its prices because it would have lost too many customers, some of whom would have switched to firm B. Following the merger, the same price increase will see fewer customers lost, since those switching to B will now be internalised within the merged entity. A price increase that was unprofitable before the merger may become profitable after.

135. The size of the post-merger price increase depends mainly on two factors: the size of the gross margin, measured as the difference between price and incremental cost; and the diversion ratios between the merging brands, measured as the proportion of the sales lost by the brand whose price is increased captured by the brand of the merger partner. The diversion ratio is closely related to the cross-price elasticity of demand between the two brands, and hence to their degree of substitutability.

136. The Bertrand pricing model combined with a model of market demand can be used to generate estimates of post-merger price increases. This model can be applied in greatly simplified form by using a number of strong assumptions about the nature of market, as suggested by Shapiro, one of the pioneers of this form of analysis.[25] There are two steps to the analysis: the first is to estimate the diversion ratio, and the second is to estimate, based upon the diversion ratio and the industry pre-merger gross margin, the post-merger price increase.

137. The results of the analysis are summarised in Table 2. As it was impractical to apply the analysis to all of the local markets, two approaches were used. The first was based on the national market shares of the three pre-merger companies, on the grounds that this would represent the position in the average local market (see 'Average' market in Table 2). The second approach focused on those local markets singled out in Decision 438 as being 'sensitive' ones where aggregation of market share was high. It is considered that these two would provide a measure of the likely range of post-merger price increases generated by the model. The market shares used are those in Table 1, and exclude the effect of proposed divestments in two markets.

138. The results also depend upon whether demand is assumed to be linear (a straight line) or constant price elasticity. The Commission tends to favour the former unless there are good grounds for believing demand is constant elasticity. A gross margin of 4% is assumed, the low margin reflecting the nature of the supermarket business.

139. As Table 2 shows, the model's predictions are that price is likely to increase post-merger by no more than 1% in the 'average' market, and that even in the 'sensitive'

[25] Carl Shapiro, "Mergers with Differentiated Products", *Antitrust*, spring 1996, pp. 23-30. Readers are referred to this article for details of the approach applied here.

markets (aside from Te Awamutu, where monopoly would arise), the predicted increase might not be more than 2%.

TABLE 2
Estimates of Post-Merger Price Increases in 'Average' and Selected Local Markets

Market	Diversion ratio	Post-merger price increase	
		Linear demand	Constant elasticity demand
'Average'	0.216	0.6%	1.2%
Te Awamutu	1.000	N/a	N/a
North Shore Auckland	0.400	1.3%	2.9%
West Auckland	0.422	1.5%	3.1%
Nelson/Stoke/Richmond	0.244	0.6%	1.4%
Tauranga/Mt Maunganui	0.319	0.9%	2.0%

140. However, it is important to emphasise that while such low price increases are consistent with what would be expected in a market where margins are extremely low by the standards of most industries, the estimates do rely upon a number of strong assumptions about the nature of the market which may not be borne out in practice. These assumptions are as follows:

?? The model incorporates the demand-side only, and does not take account of the potential for firms to re-position their banners in response to efforts by the merged entity to exert market power. If such re-positioning were to occur, its incorporation into the model would serve to reduce post-merger market power.

?? It is assumed that the costs of the companies will not change as a result of the merger. The incorporation of any efficiency gains would tend to offset post-merger price increases.

?? It is assumed that market size would remain unchanged. However, this may be too strong an assumption for metropolitan areas where some shoppers may move between different local markets, thereby helping to nullify attempts to raise prices.

?? It is assumed that products are equally 'close' or 'distant' in product space, and that diversion ratios are symmetrical, which is not the case. This factor may lead to an understatement of the post-merger price increase.

?? Each supermarket company is assumed to operate a single banner in the market, which may not be the case in some markets. This might lead to an underestimate of the price increases in those markets.

?? Simulations have suggested that although non-merging firms tend to respond to mergers by also increasing their prices, they tend to do so to a lesser extent than the merged entity.

141. Taking all of these factors into account, the estimates indicate that the possible price rise from enhanced unilateral market power following the acquisition, at least in the context of the Bertrand model, is unlikely to be high. This is consistent with the rule-of-thumb that the low gross margins, as are found in the industry, tend to yield low merger-induced price increases. However, the estimates are only very rough figures, especially in the light of the strong assumptions used, which, if they were relaxed through the use of a more sophisticated model, could drive the results either way. It was not possible to apply a more sophisticated model given the time, data and resource constraints that apply in a clearance application.

142. In addition, the model may underestimate the total effect of the acquisition by focusing solely on price. There may be simultaneous losses of other elements in the price/quality mix that form the overall offering. For example, it is possible that following the acquisition there may be a rationalisation of banners, and perhaps the closure of some stores. There may also be a lessening of service in some stores, if part of the service quality is driven by competition. As a loss in service can be seen as equivalent to a rise in price, all else being the same, the post-merger price rise could exceed that estimated by the model when those factors are into account.

143. A further consideration is the size of the post-merger increase in price, relative to the counterfactual, that is needed for competition to be considered to be substantially lessened by a merger. Earlier, it was suggested that as a broad guide, and subject to various caveats, the Commission will consider a potential price rise of 4-5% to be sufficient to constitute a substantial lessening of competition. However, it could be argued that given the huge volume of sales of the supermarket industry—amounting to several billions of dollars—and the potential consumer detriment associated with even a relatively small price increase, a figure of less than 4-5% might be warranted.

144. As already noted above, oligopoly markets also lend themselves to cooperative behaviour, in which market power can arise through coordination between firms. This is considered below.

Scope for the Exercise of Coordinated Market Power

Introduction

145. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.

146. Coordination can be either "tacit" or "explicit". Explicit coordination covers formal agreements, arrangements, or cartels, where parties formally come to an agreement on output or prices. Tacit coordination covers facilitating devices such as price signalling,

conscious parallelism and price leadership. Tacit coordination can amount to no more than an understanding between market participants. A business acquisition that materially enhances the potential for either form of coordination is deemed to be a substantial lessening of competition.

147. In broad terms, successful coordination can be thought of as requiring two ingredients: 'collusion' and 'discipline'. 'Collusion' involves the firms individually coming to a mutually profitable expectation or agreement over coordination; 'discipline' requires that firms that would deviate from the understanding are detected and punished (thereby eliminating the short-term profit to be gained by the firm from deviating).

148. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.

Collusion

149. "Collusion" involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.

150. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column in Table 3. The significance of these is explained more fully in the Commission's *Practice Note 4*. The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the supermarket market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'collusion'; a high proportion of 'no' responses the reverse. It is noted that some factors listed below may not be relevant to a given market.

TABLE 3:
Testing the Potential for 'Collusion' in the Supermarket Retail Market

Factors conducive to collusion	Presence of factors in the market
High seller concentration	Yes
Undifferentiated product	No
New entry slow	Yes
Lack of fringe competitors	Yes
Price inelastic demand curve	Yes
Industry's poor competition record	No
Presence of excess capacity	Not relevant
Presence of industry associations/fora etc	No

High Seller Concentration

151. A higher seller concentration facilitates collusion in a market. A higher concentration generally means that there are fewer firms whose actions need to be coordinated, and increases the certainty of the reaction by the market to an action by one player. Greater parity in size increases the commonality in interest between market participants.

152. As discussed earlier, the three firm concentration ratio will be 100% in any given area. Perhaps of greater concern (for the prospect of coordinated market power) is that the market will be significantly more evenly balanced in terms of market share. Prior to the acquisition the average market split was roughly 2:1:1 (in favour of Foodstuffs); after it will close to 1:1.[26]

153. In markets where there are companies of differing sizes, and economies accrue from volumes (such is the case in the current supermarket market), there are strong incentives for the smaller firms to gain market share. The firm with the largest market share equally does not want to lose the advantage it has over the smaller firms. In a scenario where there are two equal firms, there is a greater chance that they will recognise the mutual gains from cooperating rather than competing, leading to a higher price level.

154. The Commission recognises that the mere fact that the market will be going from three to two does not in itself suggest that there will be tacit or explicit collusion as a result of the acquisition. In some circumstances such a reduction in market participants may lead to an enhancement of competition (particularly if efficiency gains are realised). It is noted by the Commission that such a high concentration level is unusual compared to the supermarket industry in other countries. The Commission also notes that other jurisdictions have shown strong concerns where mergers have led to a reduction from three to two. For example, in the *Wattyl/Courtaulds/Taubmans/Pinchin Johnson* Application for Authorisation 17 May 1996, Australia, the ACCC noted:

> "A reduction from three large firms to two makes the emergence of cooperative behaviour almost inevitable even if the firms do not consciously seek to cooperate. …cooperative uncertainty as to a rival's reaction is reduced substantially as each firm is easily able to monitor the activities of the other. It may, however, take a period of experimentation to establish a cooperative outcome."

155. However, the ACCC went on to say that:

> "…there is not a nexus between concentration and competition. …the likelihood of cooperative behaviour depends crucially on other structural

[26] In the *Wattyl/Courtaulds/Taubmans/Pinchin Johnson* Authorisation Application (17 May 1996, Australia) the ACCC noted "In a market of three firms where one firm achieves scale economies in production and distribution, much of the competition which exists in the market may come from the smaller second and third firms each trying to gain market share to achieve these economies. A merger of the second and third largest firms removes the rivalry at this level and thus removes the need for the largest firm to respond to the price competition of its smaller rivals." p 65.

features … {particularly}…absence of strong international competition and if barriers are high."

156. The US Federal Trade Commission ("FTC") recently sought an injunction to block H J Heinz from acquiring Beech-Nut (a rival in the baby food market).[27] This would have led to effective reduction in firms from three to two; Heinz and Beech-Nut were the second and third largest firms in the market, with market shares of 17.4% and 15.4% respectively, while the market leader, Gerber, had a 65% market share. The US Court of Appeals ruled in favour of the FTC. The Court was strongly influenced by the combination of high concentration level[28] and high barriers to entry, stating, inter alia:

> "Merger law 'rests upon the theory that, where rivals are few, firms will be able to coordinate their behaviour, either by overt collusion or implicit understanding, in order to restrict output and achieve profits above competitive levels.'…Increases in concentration above certain levels are thought to raise[ ] a likelihood of 'interdependent anti-competitive conduct'"[29]
>
> and
>
> "The combination of a concentrated market and barriers to entry is a recipe for price coordination."[30]

157. The Commission is of the view that while three to two does not automatically imply tacit collusion, it does warrant careful consideration of the other factors that facilitate collusion and discipline.

Undifferentiated Product

158. An undifferentiated product makes it easier to come to agreement on prices, and avoids problems associated with variations in quality, changes over time in the nature of the product, and variations between firms in associated services. When there is a high level of differentiation it increases the complexity of the coordination needed to set a common price. When the product is standardised, and the competition is mostly on price, coordination becomes much easier.

159. The NZIER report[31] submitted by Progressive does not directly address the question of product homogeneity, although it has suggested that the overall likelihood of

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[27] *FTC v H.J. Heinz Co and Milnot Holdings Corp* US 6th Circuit Court of Appeals, Trade cases 2001-1, 73,243.
[28] The FTC uses the Herfindahl-Hirschmann Index ("HHI") as a guide to concentration levels. The HHI is calculated by totalling the squares of the market shares of every firm in the relevant market. Under the US merger guideline a market with a post-merger HHI above 1800 is considered "highly concentrated" and mergers that increase the HHI in such a market by over 50 points "potentially raise significant competitive concerns". Mergers that increase the HHI over 100 points are presumed likely to create or enhance market power or facilitate its exercise. The Heinz/Beech-Nut merger had a post-merger HHI of 5285, which represented an increase of 510 points. As a comparison, (if average market shares of 55%, 25%, and 20% are used) the Progressive/Woolworths merger will have a post-merger HHI of 5050, representing an increase of 1000 points.
[29] Supra 90,110.
[30] Ibid 90,116.
[31] Stephen Gale, John Feil, and Anna McKinlay, "Supermarket Merger Analysis – Report to Progressive Enterprises", NZIER, October 2001.

coordination is low due to the complexity of coordinating across all the individual products. It noted:

> "The number of products sold by a typical supermarket combined with the number of specials (Progressive advises that it may have as many as 2200 products on special in any given week) would make monitoring difficult, let alone analysing and responding to price information on this number of products" (p 21)

160. The CRA report[32], commissioned by Foodstuffs (Auckland), responded by arguing:

> "…the key issue is not product complexity but product homogeneity, since the coordination of prices is most easily achieved when products are homogeneous. Many of the goods and services provided by supermarkets are homogeneous, with the result that coordinated action is likely to be a feature of the market." (pp 30-31)

161. It would appear to the Commission that there are two components to the product at issue. When looking strictly at the goods being retailed it would appear there is a high degree of homogeneity. This is especially true for those goods that are regularly specialled, such as Coca Cola and baked beans. However, on top of this is the price/service positioning of the supermarket banner. Currently, the market is spread along a price/service continuum, with a price differential of around 5-10%. The market can therefore be considered to have some differentiation.

162. CRA does not believe this would inhibit coordination. This is because there is centralised control of pricing, which controls the relative prices between stores in different segments. Commission staff have observed that an enormous amount of resources are put into monitoring prices of rival supermarkets, and to maintaining price relativities. Firms' pricing strategies all appear to be on the basis of a rival banner plus (or minus) a margin. The firms have the ability to create an single price index that encapsulating most of the products. It would appear that the differentiation is not so strong that rivals cannot place a value on it.

163. The Commission concludes that although some differentiation exists, it is not such as to preclude potential for collusion.

<u>Speed of New Entry</u>

164. The speed of entry into the market is a factor in determining the incentives to collude. If the speed of new entry is slow, then the potential gains from colluding is high. If the speed of new entry is fast, then any profits gained from colluding will quickly be eroded by new entry.

165. For the supermarket market, the speed of entry is slow due to barriers to entry such as finding sites and obtaining resource consents. These barriers will be discussed further under "Constraints from Market Entry", where it is found that barriers are high.

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[32] "Progressive's Proposed Acquisition of Woolworths – A Competition Analysis", Charles Rivers Associates, 9 November 2001.

166. In the current application, Progressive has argued that new entry is not "necessarily" slow. The NZIER report expanded on this viewpoint by noting three potential methods of new entry or expansion. These were:

(a) new supermarket facilities – which it is claimed can take only 6-9 months;

(b) expansion of existing facilities – either by simply increasing sales or extending existing buildings; and

(c) expansion of fringe competitors.

167. Aside from the Commission's view, that in practise a realistic timeframe for the development of a new supermarket (or even extension of an existing one) is considerably more than 6-9 months, the Commission considers both point (a) and (b) irrelevant in the context of potential for coordination. The speed of entry criteria requires the potential for an entrant that is not a party to the collusion. This would require *de novo* entry, which the Commission believes to be unlikely to occur within the prescribed timeframe.

168. The Commission gives limited credence to point (c). As discussed below, fringe competitors refer to competitors within the defined market but which are small. On this basis non-supermarket competitors cannot really be defined as being fringe competitors.

<u>Lack of Fringe Competitors</u>

169. The existence of fringe competitors can often provide constraint against collusive behaviour of firms in the market. Fringe competitors are often a source of competition, and given their small size, have strong incentives to cheat on any collusive behaviour by the incumbents. This can disrupt attempts to raise prices.

170. Progressive has argued that fringe competitors do exist. These are non-supermarket fringe competitors including convenience stores, specialist stores, and petrol stations, The Warehouse and others. The NZIER report claims:

> "There is a large number of fringe competitors nationally, competing with various aspects of supermarkets' business. Were prices to increase substantially above competitive levels, fringe competitors supplying one or more of the range of products sold by supermarkets could be expected to increase capacity in response." (p 22)

171. Progressive also quotes Posner and Easterbrook (1981) in saying:

> " Any part of the market outside the scope of any coordinated pricing provides a constraint on the extent to which prices can in fact be raised." (p 11)

172. In this case, the market has been defined only to include supermarkets, so non-supermarket competitors should not technically be classed as fringe competitors. Market boundaries are not always clear though, and the Commission has accepted in this case that non-supermarkets competitors do provide some constraint on the fringes. This is particularly so for meat and produce, which appear to come into some supermarkets' considerations when setting price. However, as discussed earlier under market definition, non-supermarket competitors are extremely limited in their ability to offer constraint for one or more of the following reasons: the inability to offer the one-stop-shop; higher prices; or lack of range. Therefore, these fringe competitors are unlikely to impose any real threat if the supermarkets were to collectively raise prices by a *ssnip*.

Price Inelastic Demand

173. If the market demand for a product is price inelastic (that is, demand is not very responsive to changes in price) there is greater scope for profiteering through collusion. Inelastic goods are those that the consumer considers as necessary, and will continue to buy, even at prices well above the competitive level.

174. Foodstuffs (Auckland) has advised that [ ] Foodstuffs (Auckland) believed this is because groceries are a "relatively inelastic good". This is consistent with demand for good being price inelastic.

175. So, while the demand on a product by product basis is likely to vary considerably due to varying levels of "necessity" across products, and of cross-elasticity[33] between products, the Commission is of the view that the demand for the retailing of grocery items, taken together, is very likely to be inelastic.

Industry Competition Record

176. The industry's competition record under sections 27, 29 and 30 are considered as possible indicators of the prior willingness of the firms to engage in collusion, and suitability of conditions to do so.

177. As noted by Progressive, there have been no cases taken by the Commission alleging explicit collusive behaviour between supermarkets. The industry has not previously been considered for tacit collusion as this is not an offence under the Commerce Act 1986.

Excess Capacity

178. The presence of excess capacity in the industry may reflect output restrictions stemming from coordination already occurring in the market. It is difficult to assess capacity in the supermarket industry. Assessment of excess capacity is unlikely to be relevant in this context.

Presence of Industry Associations/Fora

179. The presence of industry association/fora, or evidence of cooperative actions or attitudes among firms, may enhance the possibility of coordination. Regular communication between firms decreases uncertainties and improves knowledge, facilitating the potential for coordination.

180. Industry associations and fora facilitate collusion by allowing players in the market to monitor the less visible actions of other players. For example, industry players may learn of new innovations or investments by competitors. In some circumstances industry associations may contribute to a sense of friendliness or cooperation amongst players and discourage more aggressive behaviour.

181. The Commission is aware that the supermarkets do share some commonalities of associations. However, there is no evidence of any undue communication between the supermarkets. Despite this, the Commission is of the view that the high level of transparency within the industry mean such fora are not strictly necessary to enable close

[33] The change in the amount of one good purchased in response to a change in price of another.

monitoring. Intense scrutiny of each other already exists, and supermarkets are generally very aware of each others actions.

<u>Potential for Collusion</u>

182. The assessment of the relevant structural and behavioural conditions in the supermarket retail market in Table 3 suggests that the market is likely to be susceptible to collusion, after the acquisition. The market demand has been shown to be price inelastic in nature. Therefore, there is scope for profiteering through collusion. Furthermore, new entry is likely to be slow, so the colluding firms can be confident that higher prices (and profits) would be able to be maintained for some time before new entry erodes them. There is also a lack of fringe competitors that could potentially serve to disrupt the collusion. The differentiation in the market is only factor that might work against collusion. However, the differentiation does not seem to be so strong that the competitors cannot put a value on it. The reduction in the market from three to two would enhance the prospects for collusion - monitoring would become easier, there would be greater certainty over the reactions of the competitors in the market, the firms would be roughly of equal size, and there would be a greater recognition of commonality of interests.

183. Consideration of the pricing policies employed by the firms already show characteristics that could indicate tacit collusion. All firms seem to be mainly concerned with maintaining the relativity of prices rather than pricing strictly on the basis of marginal costs. Both Progressive and Woolworths [ ] This type of mentality is consistent with a leader-follower model of tacit collusion.

184. The Commission has sought to find practical examples of tacit collusion already present in the market. There are inherent difficulties in this as tacit collusion (perversely) has similar traits to perfectly competitive markets. However, it can be said that there appears to be a significant difference in the intensity of competition from region to region. This ranges from towns where there is only one supermarket present (such as Kaitaia, Dargaville, and Huntly) to areas where aggressive “price wars” would appear to exist (such as Pukekohe and Invercargill). The other areas where supermarkets appear to be closely situated, the competition seems quite placid. For example, Woolworths has advised that its [ ] stores are both in its highest priced zones, despite being quite close to [ ] stores. Woolworths has advised this is because it believes [ ] are not prepared to travel far and believes the [ ] in the area are also on a higher price level. Another example, is Napier, which according to pricing data received from Foodstuffs (Wellington), has experienced a steady upward drift of supermarket prices (all banners), far in excess of what is observed in other areas. This is despite the presence of a Pak’N Save, Countdown, and Woolworths. These local effects are likely to be augmented in addition to regional effects.

185. Given the presence of the factors that facilitate collusion, the increase in concentration, and the possibility that upward movements in prices are already present, the Commission believes there is a real likelihood that the firms in the market could take advantage of the enhanced ability to collude and further raise prices. It is noted that price increases may not be immediate – it may take some time of aggression (as the two firms jostle for market share), then experimentation (as the two firms check each others

responses), and then tacit collusion. It is also possible that the tacit collusion may manifest itself in simultaneous falls in levels of service.

186. The other way tacit collusion may occur, and perhaps the most immediate effect, is likely to be a lessening of the number and intensity of specials offered by the supermarkets. Currently, most specials are organised in advance led by either supermarkets or suppliers. Each week supermarkets will quickly react to ensure they match their competitors' offers. This is achieved by attempting to renegotiate with suppliers for the week, or self-funding the special.

187. Woolworths was of the view:

[

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188. Despite deals done with suppliers, supermarkets still must make a choice on whether to sell the goods slightly above, at, or below cost. Tacit collusion could cause a shift toward the former rather than the latter.

<u>Conclusion on Collusion</u>

189. The Commission is of the view the acquisition will materially enhance the potential for collusion.

Discipline

190. For coordination to be successful, deviations of individual firms from the collusive behaviour have to be discouraged by being detected swiftly and punished by the other firms.

191. The structural and behavioural factors that are usually considered to be conducive to 'discipline' in coordinated markets are set out in the left-hand column in Table 4. Again, the significance of these is explained more fully in the Commission's *Practice Note 4.* The right-hand column of the Table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the supermarket market. A high proportion of 'yes' responses would suggest that the market was particularly favourable to 'discipline; a high proportion of 'no' responses the reverse.

TABLE 4
Testing the Potential for "Discipline" in the Supermarket Market

Factors conducive to discipline	Presence of factors in the market
High seller concentration	Yes
Sales small and frequent	Not relevant
Absence of vertical integration	Yes
Demand slow growing	Yes
Firms have similar costs	Yes
Price transparency	Yes

192. For coordination to be successful, deviations by individual firms from the coordinated behaviour would have to be discouraged by being detected swiftly and punished by the other parties in the market.

193. This is discussed in a paper on the problem of joint dominance prepared for the New Zealand Treasury, written by L Evans, N Quigley, F Mathewson and P Hughes and submitted to the Commission by Foodstuffs (Auckland). The paper says in part:

> "{Economists of the Structure-Conduct-Performance School} took the view that collusion was inevitable in oligopoly situations and that, as a result, an active antitrust policy was needed to combat oligopolies.
>
> In a seminal article, Stigler (1964) countered this thinking by rigorously modelling the ability of oligopolists to hold together such agreements. Stigler showed that, in order for oligopolists to successfully exercise mutual constraint – ie tacit or express collusion – they would not only have to come to an agreement, but enforce that agreement in light of the incentives for a firm to "cheat". Specifically, they would have to be able to detect when their rivals acted more competitively than the agreement allowed, and be able to punish sufficiently so that short-run gains from cheating were less than the longer-run costs imposed by the punishment strategy.
>
> and:
>
> Whether an agreement can be sustained in a particular fact situation depends on the ability to overcome difficulties: (1) in reaching an agreement; (2) in detecting deviations; and (3) in establishing credible punishment strategies that are sufficient in magnitude to offset the short-run incentive to deviate."[34]

194. The structural and behavioural factors that are usually to be considered to be conducive to 'discipline' in coordinated markets are discussed below, as are whether these factors are likely to be enhanced by the proposed acquisition.

<u>High Seller Concentration</u>

195. As discussed above the acquisition would result in no more than two firms competing in the various geographic markets. There are currently three firms in many of these markets. Monitoring of rivals' behaviour is generally easier the more concentrated the market. The Commission believes that monitoring would be possible if the proposed acquisition proceeded. However there are special features about the supermarket market that must be taken into account.

196. For a start each supermarket can carry up to 24,000 lines per store, and not all prices are uniform across stores in the same banner group. The NZIER report noted that Foodstuff stores are owner-operated with owners "having substantial discretion at store level in relation to in-store specials and promotions". However, the Commission considers that in practice there appear to be significant constraints on the pricing flexibility of these owner/operators. For instance, they cannot sell advertised banner specials at prices other than those determined centrally. Also, it would be difficult for an

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[34] Lewis Evans, Neil Quigley, Frank Mathewson, and Patrick Hughes, "Threshold for the Scrutiny of Mergers and the Problem of Joint Dominance", 5 July 1999.

individual store to administer a pricing strategy that differed materially from that applying to the rest of the banner group. Nevertheless, the Commission accepts that prices are not uniform across all stores. Information provided by Foodstuffs (Auckland) indicates that the maximum variation between the cheapest and dearest Pak'N Save store is in the order of [ ]%.

197. The NZIER report has suggested that the degree of monitoring that would be necessary for tacit collusion would be difficult because it would require the involvement of each of the 163 Foodstuffs stores. The Commission considers that this overstates the case. There is a substantial degree of uniformity of prices in stores of each banner group. To the extent that banner group pricing levels vary, they tend to vary uniformly – that is, the variations between the dearest and cheapest stays reasonably uniform. Thus monitoring post-acquisition would not require checking prices in all stores, but could be undertaken by focusing on sample stores.

198. The Commission considers that the greater market concentration arising because of the acquisition would facilitate the monitoring necessary for market coordination.

Nature of Sales

199. As noted in the Commission's guidelines, the more that sales are made in frequent, small orders, the lower the profit incentive to deviate on any particular sale, and the greater the risk of detection.

200. This category is not likely to be relevant for supermarkets as there is no possibility for stores to offer "secret discounts" to individual customers. Prices are posted and available to all customers.

Vertical Integration

201. The Commission's Practice Note 4 notes that where firms in a market are vertically integrated, deviations can be concealed by individual firms by them selling to their downstream operation at a reduced price.

202. Both Progressive and Foodstuffs have grocery wholesaling and distribution subsidiaries. This up-stream vertical integration is not relevant because the buyer/seller transaction under consideration is from the supermarkets to consumers. Supermarkets do not have down-stream vertical integration at the retail level.

Growth in Demand

203. Collusion is easier to police when demand is growing slowly, such as is often the case in mature markets, where a market share gain by a deviating firm is likely to translate directly into market share losses for other firms.

204. In its report to Progressive, CoriolisResearch (Coriolis) has stated that the FMCG retailing is highly competitive and changing rapidly as the nature of society and consumer purchasing patterns change. Mr Shelton, for Progressive, has noted that supermarkets are continually changing the items they carry. Wine and beer, which are relatively new products in supermarkets, are now 2 of the top 10 selling lines.

205. Nevertheless the information provided by Coriolis indicates supermarkets as a whole have a reasonable degree of stability in demand. The report by Coriolis shows that

supermarkets' share of total food spending declined gradually from 78.5% in 1996 to 76.8% in 2000.

206. The Commission is of the view that the market can be characterised as being sufficiently mature and stable to permit the discipline necessary for price coordination.

Cost Similarities

207. Deviations are easier to detect when firms cannot conceal price cuts by claiming reduced costs.

208. The NZIER report states:

> "We understand that the variable cost share in supermarket operation is in the order of 85% and that, because of the prominence of the 'cost of sales' (80%), this feature is broadly similar across the operators. Thus the fixed cost *differences* are unlikely to destabilise tacit collusion in the presence of volatile demand conditions." (pp 25-26)

209. Subsequently the authors of the report have suggested to Commission staff that, based on additional information provided to them by Progressive, they consider that there is sufficient difference in cost structures between Progressive and Foodstuffs to make tacit collusion unlikely.

210. Notwithstanding the changed position of NZIER, the Commission considers that the costs of the two firms are likely to be broadly similar. Further, to the extent that Progressive and Foodstuffs currently adopt different operational methods – for instance Progressive puts a much greater share of its goods through central warehouses than Foodstuffs (Auckland) – it is possible that more uniform approaches will be adopted in the longer-term if it is demonstrated that one method has clear cost advantages. Progressive has expressed "achieving closer cost structures" as one reason for seeking the merger.

Price Transparency

211. Price deviations are easier to detect when price information is freely available, because of the posting of prices, information exchanges or disclosure of price bids. As noted by NZIER, transparency reduces the cost of detection, and so facilitates the discovery of deviation from coordinated prices.

212. As NZIER also notes, retail prices in supermarkets are highly transparent. Prices for each line are displayed in store, and firms in the market routinely monitor each other's prices. Further, special deals are usually advertised to the general public.

213. Nevertheless, the Commission accepts NZIER's additional point that the cost of monitoring the full range of items that might go into an individual shopper's "basket" (with possibly 24,000 items to choose from) would be very high indeed. However, the Commission does not consider that monitoring requires checking of all lines at all stores.

214. The task is further simplified when it is considered that the bulk of sales in a supermarket are made through a relatively small number of lines. These products (described as "A-line" products) include such staples as Coca-Cola, washing powder, and milk. There are around 200 A-line products, whose prices are monitored on a weekly basis. Other products are monitored on a less regular basis. All prices are checked over a six to eight week period.

215. The supermarkets also appear to reduce the complexities of the prices to a single index, which enables them to compare the relative prices among stores. This would tend to indicate that conditions are not so difficult as to make comparisons between different stores.

216. The Commission also notes that the prices of "specials", which have historically been the main element of day-to-day competition, are highly transparent. Progressive, however, has argued:

> "…many specials in supermarkets are the initiatives of suppliers, …{and}… the other supermarket chain will have no way of knowing whether specials offered by their competitor are at the initiative of the supplier or the chain…"

217. Specials are normally negotiated with the supplier well in advance, and rival supermarkets will not know the terms. However, supermarkets will normally seek to match specials – either by immediately seeking better terms with the supplier of that product (or similar product) or self-funding the special. Suppliers are currently put under strong pressure to extend any deals to other parties. For example, [ ].

Woolworths was of the view that once the market goes from three to two, [ ]

218. The Commission is therefore of the view that prices are sufficiently transparent to enable monitoring to take place.

Ability for Discipline

219. The assessment of the relevant structural and behavioural conditions in the supermarket retail market in Table 4 suggests that discipline is likely to be possible post-merger. Sales are of a small and frequent nature, meaning the profit incentive to cheat is low. Further, it is likely to be hard to hide deviations due to the lack of vertical integration, maturity of the market, cost similarities, and price transparency. The reduction of players from three to two will make monitoring easier.

220. Discipline of sorts is already present in the market. All firms closely monitor each other's prices and specials. If one offers a particularly sharp special, the others will immediately seek to match that offer, even if it is at a loss.

Conclusion on Discipline

221. The Commission considers that the ability to identify and discipline cheating will be present post-merger.

Conclusions – Coordinated Market Power

222. The Commission considers that the supermarket retail market would exhibit the following characteristics post-merger:

?? the market would be highly concentrated;

?? the firms would be relatively evenly matched in terms of market share;

?? there is only limited differentiation of the product;

- ?? new entry is likely to be slow or non-existent;
- ?? there is a lack of fringe competitors;
- ?? the firms are likely to face a price inelastic market demand curve;
- ?? sales are small and frequent;
- ?? there is no vertical integration;
- ?? the market would appear to be mature;
- ?? post-merger the firms will have similar costs; and,
- ?? prices are transparent.

223. The market appears to be one that facilitates collusion and discipline. Prices are monitored and re-set on a weekly basis. A repeated game is thus played in circumstances of near-complete information. Experimentation can occur with little loss, and deviations can be easily identified and reacted to. All of these circumstances are conducive to "leader-follower" tacit collusion. This is likely to be enhanced by the merger by the following: the reduction in the number of firms from three to two, which reduces monitoring; the increased parity in firm sizes; the direct one-to-one effect if the other should cheat; and possibly a greater parity in the firms' costs.

224. Therefore, in light of the preceding analysis and evidence, the Commission is of the view that the acquisition is likely to materially enhance the potential for coordinated market power.

Conclusions – Existing Competition

225. Consideration by the Commission of the individual geographic markets, and use of the Bertrand oligopoly model, would suggest that the merged entity would have some scope for raising its prices in a unilateral market power setting. These price rises are not anticipated to be high although the assumptions attached mean there is a degree of uncertainty of the true extent of price rises. The divestments offered In Te Awamutu and Birkenhead may help ease concerns over unilateral market power in those areas.

226. The analysis performed above suggests that the market characteristics that facilitate collusion and discipline are present, and will be enhanced by the reduction in the market from three to two. The divestments offered will not alleviate any concerns over potential for coordination. Therefore, due to the material enhancement of the potential for coordination, the Commission cannot be satisfied that existing competition would prevent the acquisition from substantially lessening competition.

CONSTRAINTS FROM MARKET ENTRY

Introduction

227. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.

228. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.

229. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Barriers to Entry

230. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.

231. The Commission considers that a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader 'entry conditions' that apply, and then go on to evaluate which of those constitute entry barriers.

232. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

233. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.

Barriers Assessed in Decision 438

234. In Decision 438 the Commission found that barriers to entry were high (see paragraphs 93-103). This made expansion by existing players not sufficient to constrain the merged entity, but also made *de novo* entry by a new chain particularly remote. A brief description of the barriers to entry as assessed in Decision 438 follows.

<u>Economies of Scale/Critical Mass</u>

235. To be a viable and effective operator, the Commission noted that a supermarket chain must achieve a minimum economic size to justify the capital expenditure and other infrastructure costs. Size is also necessary to achieve "buying clout" with suppliers. This meant that effective entry is only likely to be viable on a large scale. Given the maturity of the market, difficulty in gaining sites, and satisfying planning laws, *de novo* entry of a new chain was not considered likely.

236. The economies of scale in a single supermarket also act as a barrier to entry. Many markets are not able to support further supermarkets than currently exist. For example, Foodstuffs (Auckland) has advised that it had [ ].

Access to Suitable Sites

237. The Commission found that access to suitable sites is often a major impediment to entry. Good sites are particularly difficult to find in metropolitan areas. Sometimes supermarket chains are required to purchase several individual parcels of land to aggregate a sufficient area for a supermarket.

Resource Consents

238. Obtaining the necessary resource consents was found to be a major barrier to entry. In many instances, obtaining the necessary regulatory approvals has taken several years. Resource consents are also required for expansion of supermarkets.

239. The amount of time resource consents take varies depending on the zoning of the land, number of parties affected by the development, and goals of the local authorities. In general, the gaining of resource consents combined with the time for construction was found to be outside the prescribed two year time frame.

Conclusion in Decision 438

240. The Commission concluded that the above barriers represented significant impedients to the potential of a new entrant into the supermarket market. It was, therefore, not satisfied that *de novo* entry could be relied on to constrain the merged entity. The scope for expansion of an existing player into a specific geographic market was generally considered unlikely to sufficiently constrain the merged entity (although this varied to some extent depending on the area). Even expansion of an existing site was typically not an easy or swift process.

Current Application

241. Progressive has submitted that barriers to entry are not as high as considered by the Commission in Decision 438. While the Commission recognised such examples as Wairau Park (when resource consent problems have delayed construction for over ten years), Progressive would appear to be arguing that this is the exception rather than the rule. A discussion on the arguments forwarded by Progressive ensues.

242. Progressive refers to previous decisions made by the Commission in arguing that *de novo* entry could take place within a relatively short time frame. Progressive refers to three internal memoranda that considered supermarket mergers in 1992 and 1993.[35] Commission staff found that:

> "…despite difficulties which individual prospective entrants might face in obtaining suitable sites, these difficulties ware not such as to preclude entry."

243. While the relevant consideration is the current barriers to entry, it is noted that the implications of the Resource Management Act (which had only been in place for around a year) do not appear to have been fully recognised. The assessment of barriers to entry in

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[35] Acquisition of Foodstuffs (Wellington) Cooperative Society Ltd of Countdown Foodmarkets Ltd, report dated 25 March 1992; Acquisition by Foodstuffs (South Island) Ltd of Countdown Foodmarkets Ltd, report dated 7 April 1992; and Acquisition of Foodland Holdings Ltd of Progressive Enterprises Ltd, report dated 1 July 1993.

this decision is based on information received during the Decision 438 and the current investigation.

244. Progressive has also noted that in its application that:

> "There appears to be a trend towards "mega centre" shopping hubs (zoned specifically for the activity) and also a trend towards locating new supermarket stores close to motorway or major highway access points with less emphasis on being in the heart of population centres. … In these situations there is less reason to expect that RMA consents will be a significant obstacle." (p 17)
>
> and
>
> "It is also common for supermarket chains to take leases in new greenfields shopping centres as anchor tenants. In those situations the problems of resource consents are often avoided…" (p 17)

245. The above are situations where developing a supermarket is likely to be relatively quick as the developer will already have obtained resource consents, or the zoning is such that resource consents are not required. However, the Commission's view is that the availability of such sites in a given area is likely to be uncertain. Therefore, they cannot be relied on as a general remedy for market power.

246. To test Progressive's assertions, the Commission has sought information from all five supermarket chains on supermarket developments. The five chains were asked to provide information on recently opened supermarkets about how long it took to bring it into operation. The information is summarised in Table 5 :

Table 5:
Time Taken for Development of Supermarkets

Company	Observations	Average (months)	High	Low
Progressive	7	12.7	20	8
Woolworths	14	19.8	60	6
Foodstuffs (Auckland)	8	73.1	132	27
Foodstuffs (Wellington)	5	64.2	120	34
Foodstuffs (South Island)	10	55.7	156	0

247. There is a substantial discrepancy in the average for Progressive and Woolworths, versus those for the Foodstuffs companies. Enquiries have revealed that the variation in average timeframes mainly reflects the different property development strategies adopted by the respective companies. The different strategies can be summarised as follows:

?? Foodstuffs has a strong preference for ownership of a site, and having stand-alone sites for its Pak'N Save stores. Foodstuffs (South Island) has advised it adopts this strategy as it gives it greater flexibility for its sites in terms of innovations, renovations, and extensions. The examples provided by the Foodstuffs companies include instances where they purchased small parcels of land over several years until they aggregated sufficient land for a supermarket.

?? The Foodstuffs companies also appear to be more aggressive in buying sites. Several sites they purchased are not in the correct zoning, but they are prepared to either “wait it out” or fight to have the land rezoned (which is the case at Wairau Road). This strategy can produce some extremely drawn out processes.

?? The figures provided by Woolworths’ were calculated on the basis of when the “mental commitment” to build a supermarket was made. It does not include preliminary activities such as searching for a site, the economic analysis, and so forth. Woolworths noted that in several instances it sought a site for some time but was unable to find one (such as in [ ] area). Its average in the table above is, therefore, likely to be understated.

?? Similarly, the information provided by Progressive does not include lead-up work required to come to a decision to construct a supermarket. Progressive has advised that this can range from a few months to several years.

?? Some of the timeframes provided by Progressive may also be slightly misleading because they do not take into account delays and difficulties borne by the developer. This is the case in malls and in retail developments mentioned earlier. Because the difficulty of resource consents has already been taken care of by the developer, it can reduce the opening of a supermarket to the time it takes to physically build (that is, 6-9 months).

248. It would therefore appear that the figures supplied by the three Foodstuffs companies are likely to exaggerate the time required to bring a supermarket into operation, while the figures provided by Progressive and Woolworths are likely to understate it. On balance, for the purposes of the competition analysis, the Commission will maintain its general view that barriers to entry and expansion are high.

The “LET” Test

249. The above analysis considers the ability of an existing competitor to expand its chain to respond to the exercise of market power to the merged entity. The LET test below considers the potential for *de novo* entry of a new chain.

250. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that a business acquisition could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be <u>l</u>ikely, sufficient in <u>e</u>xtent and <u>t</u>imely (the *let* test). If they are to act as a constraint on market participants following a business acquisition which might otherwise lead to a substantial lessening of competition in a market, entry must be relatively easy, or to put it another way, barriers to entry must be relatively low.

<u>Likelihood of Entry</u>

251. The mere possibility of entry is, in the Commission’s view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.

252. In general, it is the pre-merger price that is relevant for judging whether entry is likely to be profitable. In respect of the supermarket market, entry may also be dependent on the new entrant finding a position in the market that is sufficiently different from the incumbent chains.

253. It is likely that because a new entrant's expansion will take place over a long period, it will be some time before it reaches the necessary economies of scale to compete on an equal basis to the incumbent supermarkets. It is has the choice of having higher prices (in which case it is unlikely it will gain market share and the economies that come with it), or match its competitors' prices and accept short-term losses. The latter is, perhaps, more realistic.

254. However, as noted by Progressive, all three (five when Foodstuffs companies are considered separately) established supermarket chains are profitable. Therefore, if a new entrant were to get a reasonable share of the market, there is no reason to believe it would not make long-term profits. It is, of course, questionable whether longer term profits would be sufficient to cancel out losses in the shorter term.

Extent of Entry

255. If entry is to constrain market participants, then the threat of entry must be at a level and spread of sales that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.

256. Small-scale entry into a market, where the entrant supplies one significant customer, or a particular product or geographic niche, may not be difficult to accomplish. However, further expansion from that "toe-hold" position may be difficult because of the presence of mobility barriers, which may hinder firm's efforts to expand from one part of the market to another. Where mobility barriers are present in a market, they may reduce the 'extent' of entry.

257. The Commission reiterates that small scale entry into the supermarket market would not be viable. On the basis that a new entrant has made a long-term commitment to the market, its spread is likely to be slow and haphazard as it goes through the process of finding sites, and going through the various regulatory requirements. In general, it is likely that it would be some time before a new entrant would provide meaningful or widespread constraint. Speeding up the process is likely to mean accepting low quality sites.

258. The Commission is of the view that the "extent" component of the LET test is not met.

Timeliness of Entry

259. If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant

extent. Entry that constrains must be feasible within a reasonably short timeframe from the point at which market power is first exercised.

260. While there are likely to be some instances where the entire process involved in the development of a supermarket will be less than two years, the likely time period is longer than this. This applies with much greater force to the establishment of a new chain that could compete nationwide. Therefore, the Commission is of the view that the "timeliness" component of the LET test is not met.

<u>Conclusion on the LET Test</u>

261. The Commission is of the view that neither the "extent" or "timeliness" components of the LET test are met. The market therefore fails the LET test for new entry.

Views of Possible De Novo Entrants

262. The Commission has discussed the potential for *de novo* entry into the market with The Warehouse, Aldi, and Woolworths (Australia). The responses were as follows:

?? The Warehouse advised that many goods are competing for shelf space in its stores, grocery items are well down the order due to their low margins. The Warehouse also advised that it was not interested in supplying fresh goods. The likelihood of The Warehouse entering the market is therefore considered to be very low.

?? Aldi was consulted during the investigation of Decision 438. It has confirmed that its position remains unchanged. This position was that [

]

Woolworths (Australia) was consulted on the potential for entry into the New Zealand market. Woolworths advised that [

]

263. These responses are consistent with the Commission's views that *de novo* entry is not likely to take place within the necessary time frame. It is also noted that the Commission has not found any examples of recent successful *de novo* entry to the market. While new banners such as Pak'N Save and Big Fresh have been introduced to the market, there has been no *de novo* entry by a firm in over ten years. This further strengthens the Commission's view that there are real and significant barriers to entry, and that entry is not likely to be a constraining force in respect of the merged entity.

Conclusion on Barriers to Entry

264. The Commission concludes that the barriers to entry and expansion are high. The Commission also concludes the LET test is not met, and therefore new entry can not be relied on to provide constraint to the merged entity. The evidence suggests that the ability of supermarkets to respond in a timely fashion to the exercise of market power is limited,

while the prospect of *de novo* entry to satisfy market power concerns is particularly remote.

OTHER COMPETITION FACTORS

Elimination of a Vigorous and Effective Competitor

265. Sometimes an industry contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is regarded as a maverick. The independent or less predictable behaviour of such a firm may be an important source of competition in the market, and may undermine efforts by other firms to engage in coordination. Such a firm need not be large to have an impact on competition out of proportion to its relative market size. Should it become the target of a business acquisition, the resulting elimination of a vigorous and effective competitor could have the effect of substantially lessening competition in the market (especially if there are barriers preventing the entry of new, effective competitors).

266. The Commission considers Woolworths to be a viable competitor, but is not sufficiently different to the other chains for it to be considered a vigorous or maverick competitor.

Constraint from Buyers or Suppliers

267. The potential for a firm to wield market power may be constrained by countervailing power in the hands of its customers, or alternatively, when considering buyer (oligopsony or monopsony) market power, its suppliers. In some circumstances, it is possible that this constraint may be sufficient to eliminate concerns that a business acquisition may lead to a substantial lessening of competition.

268. Where a combined entity would face a purchaser or supplier with a substantial degree of market power in a market affected by the acquisition, the Commission will consider whether that situation is such as to constrain market participants to such an extent that competition is not substantially lessened.

269. There would appear to be little or no ability for buyers or suppliers to constrain supermarkets.

Efficiencies

270. As noted in Practice Note 4, there may be circumstances where efficiencies from an acquisition can be relevant to an application for a clearance. The combined entity might be able to make efficiency gains that are not obtainable by other means, such that the unit cost of production would decline. It is conceivable that this could result in the entity reducing its price below that obtaining prior to the acquisition, even though with the acquisition it would otherwise be considered to have substantially lessened competition, and would be able to raise prices above costs. Practice Note 4 states:

> "Where the applicant can make a sound and credible case that such efficiencies will be realised, that they cannot be realised without the acquisition, and that they will enhance competition in the relevant market, the Commission will include them in the broader analysis of all the

> competitive effects of the acquisition in the course of assessing whether or not competition is likely to be substantially lessened. Those other effects might also include the scope for product quality to be eroded as the result of the lessening of competition.

271. The Commission envisages that efficiency claims of the required magnitude and credibility will only very rarely overturn a finding that competition would otherwise be substantially lessened."

272. The NZIER report has suggested that in this case the main sources of additional efficiency arising from the proposed acquisition are reduction in support overheads, improved utilisation of distribution systems, reduced supplier transaction costs, and greater focus on centralised distribution.

273. The Commission accepts that the acquisition would be likely to result in some cost savings from economies of scale, for example, although no doubt there would be significant costs incurred in introducing such things as common management and distribution systems. Progressive has not provided, nor has the Commission sought, details of possible efficiency gains and the cost of achieving them.

274. The Commission does not consider that it can be sufficiently confident that any efficiency gains are likely to be material, or are likely to be passed on in lower prices, for it to give weight to them in the analysis of the competitive impact of the acquisition.

Conclusion on Market for the Retailing of Groceries in Supermarkets

275. The Commission has considered the probable nature and extent of competition that would exist in the supermarket market. The following points are noted:

?? In terms of the scope for the exercise of unilateral market power, there will be several markets in which the merged entity will have market share outside the Commission's safe harbours. The Commission has used the Bertrand Model to estimate possible post-merger price rises. The assessed price rises are not expected to be high, although the assumptions attached to the model make it difficult to be certain of the post-merger outcome.

?? In terms of the scope for exercise of coordinated market power, the factors that facilitate collusion and discipline appear to be present. The market is highly concentrated, with the two firm concentration ratio for all markets being 100%. The reduction of three to two players is considered likely to materially increase the potential for coordinated market power, and substantially lessen competition. The divestment undertaking will not alleviate these concerns.

?? The Commission is of the view there are high barriers to entry, and that the threat of new entry is unlikely to be a constraint.

?? The Commission has been unable to identify any other competition factors that would prevent a substantial lessening of competition (such as constraint from buyers or sellers, or efficiency arguments).

276. Progressive will gain additional unilateral power through the acquisition, but whether the gain in unilateral power is sufficient to substantially lessen competition is ambiguous. The Commission has not had to resolve this issue as it is of the view that the acquisition will result in a material increase in the potential for coordinated market power, which alone is sufficient grounds for a decline.

277. In light of the above conclusions, the Commission is therefore not satisfied that the proposed acquisition would not have, nor would not be likely to have, the effect of substantially lessening competition in the market for the retailing of grocery items in supermarkets.

THE NATIONAL MARKET FOR THE WHOLESALE SUPPLY OF GROCERIES

Introduction

278. During the investigation of Decision 438 concerns were raised that the acquisition would create a dominant buyer. The wholesale (purchasing) market was considered in Decision 438 by the Commission but not deemed to be of concern. The merged entity's market share was within the safe harbours, even on a very conservative basis of only considering the supermarket distribution channel. Other channels existed, including specialists, the route trade and export. These were not included in the market share assessment for ease of analysis. The three Foodstuffs companies were found to be able competitors in this market.

Competition Analysis

279. The Commission has considered whether the acquisition might substantially lessen competition in this market. Based on AC Neilson data the market share of the combined entity (nationally) would be around 45%. This is to be used as a proxy for the proportion of sales by suppliers to supermarkets that are accounted for by the merged entity. The same approach was used in Decision 438 (see paragraphs 199-201).

280. As noted in Decision 438, overall this is likely to represent a worse case scenario for the merged entity, in terms of market share. Although supermarkets are a very important distribution channel, they are not the only one. Other channels include the route trade (for those not supplied by supermarket-owned distributors), category killers[36] (such as Pumpkin Planet), and export. It was observed in Decision 438 that for some suppliers, supermarkets accounted for a very small proportion of their production.

281. Market share of 45% is slightly above the Commission's safe harbour for unilateral power. However, this is not considered reflective of a substantial amount of unilateral market power. The merged entity will continue to face competition from the three Foodstuffs' companies.

282. The three firm concentration ratio of this market is likely to be around 85%. That is, the approximate aggregate of the merged entity, Foodstuffs (Auckland) and Foodstuffs (Wellington). This is outside the Commission's prescribed safe harbour for coordinated market power.

283. The market, however, would not appear to be one that would facilitate coordinated power. The following factors are likely to militate against coordinated market power:

[36] "Category killers" refers to those chains/outlets specialising in just one category.

- ?? prices are not transparent. Suppliers have advised that although the basic terms of trade are visible, rebates, discounts, promotional spend and so forth are not. Therefore, supermarkets are not aware of the precise price paid by their rivals;
- ?? sales are not as small and frequent as for the retail market;
- ?? there is some vertical integration. Woolworths and Progressive have meat processing plants, and Foodstuffs (Wellington) has its own milk processing plant;
- ?? for many goods there exists “fringe” competitors prepared to purchase goods. For example, for fruit and vegetables this would include specialists such as Pumpkin Planet; and,
- ?? the four firms in the market will be of different size.

Conclusion on the Wholesale Market

284. The Commission is satisfied the acquisition would not result in, or would be likely to result in, a substantially lessening of competition in the national purchasing market for the wholesale supply of groceries.

DETERMINATION ON NOTICE OF CLEARANCE

285. Accordingly, pursuant to section 66(3)b of the Commerce Act 1986, the Commission declines to give clearance for the business acquisition by Progressive Enterprises Limited of the shares in Woolworths (New Zealand) Limited and/or its immediate holding company Denstree Corporation Limited.

Dated this 14th day of December 2001

P R Rebstock
Deputy Chair