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Economic effects of proposed merger of FSNI and FSSI – review of statement of unresolved issues

A report for Chapman Tripp

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1. Introduction

1. We have been asked by Chapman Tripp to prepare this report on behalf of the two Foodstuffs co-operatives, Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI) (collectively, Foodstuffs or the parties),[1] on the economic effects of the parties' proposed merger (proposed transaction).

2. The purpose of our report is to review the economic principles and matters arising in their application, as described in the Commerce Commission's (the Commission's) statement of unresolved issues regarding the proposed transaction (SOUI).[2] This report should be read together with our earlier reports regarding the proposed transaction.[3]

3. The remainder of this report is structured as follows:

    a. in section 2, we set out and apply the relevant economic principles in assessing the likely competitive effects of the proposed transaction;

    b. in section 3, we respond to the Commission's stated concerns regarding unilateral effects in acquisition markets; and

    c. in section 4, we respond to the Commission's stated concerns regarding coordinated effects in retail markets.

[1] We also use 'Foodstuffs' to refer to the proposed merged firm.

[2] Commerce Commission, *Statement of unresolved issues, Proposed merger of Foodstuffs North Island and Foodstuffs South Island* (SOUI), 16 July 2024.

[3] HoustonKemp, *Economic effects of proposed merger of FSNI and FSSI*, 7 March 2024 (our first report); and HoustonKemp, *Economic effects of proposed merger of FSNI and FSSI – review of statement of issues*, 26 April 2024 (our second report).

2. Relevant economic principles

4. In this section, we describe the essential economic principles relevant to assessing the potential effects of the proposed transaction, including the likely effects on competition.

5. The principal economic function of the parties is to acquire grocery products in upstream markets (referred to by the Commission as 'acquisition markets') for the purpose of on-selling those products to consumers in downstream markets for groceries[4] (referred to by the Commission as 'selling markets').[5] The parties compete with other grocery retailers, such as Woolworths, in both of these types of markets, ie, at both levels of the supply chain.

6. Presently in downstream, retail grocery markets:

   a. the parties operate in distinct geographic footprints and do not compete[6] and so there can be no loss of rivalry between them (in those markets);[7] and

   b. in each of those downstream markets, the intensity of competition with Woolworths and other relevant retailers can be taken to be at some form of equilibrium position, given the existing market structure, the relevant characteristics of each competitor, and the nature of the competitive interactions between them.

7. Meanwhile in the upstream, grocery acquisition markets, the parties largely seek to acquire independently a combination of grocery products[8] that reflect the current retail grocery market outcome.[9] Put another way, the parties' upstream demands to acquire groceries are dependent on:[10]

   a. consumer demand for groceries in the downstream markets; and

   b. the nature and intensity of competition with Woolworths and other competitors downstream.

8. From the parties' perspective, the proposed transaction is likely to result in:

   a. cost savings and efficiencies resulting from the consolidation of administrative functions, etc;[11]

   b. the parties bargaining as one in the upstream markets, and consequently experiencing a small improvement in their relative bargaining position *vis a vis* some suppliers ('buying benefits')[12] – in section 3.2.1 below we show why the expected quantum of this improvement is relatively small; and

[4] See, for example, Betancourt, R and Gautschi, D, *The economics of retail firms*, Managerial and Decision Economics, 9, 1988, pp 133-134, which explains that '…the fundamental economic function of retail firms is to deliver explicit products or services to consumers together with a variety of distribution services… [emphasis omitted]'.

[5] SOUI, para 30.

[6] SOUI, paras 63.5 and 64.

[7] See, for example, Inderst, R and Wey, C, *Buyer power and supplier incentives*, WZB discussion paper, No. SP II 2003-05, 2003, p 2, which explains that '[a]nti-competitive effects are also absent in mergers between retailing chains that operate in different geographic markets.'

[8] The parties presently jointly procure private label products. SOUI, para 63.3.

[9] Application, para 118 explains that '[t]he acquisition of grocery products takes place pursuant to, and in combination with, decisions regarding retail ranging, and *for the purpose of retail supply* [emphasis added].'

[10] Consistent with the primary function of a grocery retailer being the provision of products to consumers: see paragraph 5.

[11] Application, para 20.1.

[12] See, for example, Bhattacharyya, S and Nain, A, *Horizontal acquisitions and buying power: a product market analysis*, Journal of Financial Economics, 99(1), 2011, p 99, which '…provides direct evidence that supplier selling prices themselves decline after downstream consolidation.' See also our first report, para 60.

c. suppliers are likely to face lower costs in negotiating with one buyer (Foodstuffs), rather than with FSNI and FSSI individually.[13]

9. We explain in our first and second reports that, in respect of different types of suppliers, the bargaining position of the merged entity would either not change, not be likely to change or would be likely to improve slightly, relative to the bargaining position of FSNI and FSSI individually.[14] We also explain that the merged entity can reasonably be presumed to seek to achieve the better of the terms that each of FSNI and FSSI presently receives.[15]

10. The small change in bargaining power arising from the proposed transaction can be expected to result in a reduction in the merged entity's input costs for some acquired grocery products, ie, the merged entity's marginal cost for some grocery products will be lower than the marginal cost presently faced by one or other of FSNI and FSSI individually. Equivalently, this means that the proposed transaction can generally be expected to result in slightly lower[16] prices (on average) across the relevant upstream and acquisition markets.

11. Notwithstanding a suggestion otherwise by the Commission,[17] economic principles show that at least some part of the anticipated reduction in the merged entity's marginal cost of production will always be passed on by a profit maximising firm under *any* form of downstream competition.[18] These reduced marginal costs will therefore give effect to a new equilibrium outcome in the downstream, retail grocery market. The direction of change for this new equilibrium outcome involves:[19]

a. lower prices set by the merged entity, as compared to the prices set by FSNI and FSSI;

b. increased output for the merged entity *vis a vis* Woolworths and other retailers (resulting from those lower prices); and

c. for the market overall, lower market prices and higher output, ie, increased sales of grocery products.

12. By consequence of there being greater output in the downstream market, there must also be an increase in total output across the relevant upstream markets. In our view, a circumstance in which output is increasing and prices are falling (both upstream and downstream) is not consistent with a substantial lessening of competition in any market in which the parties compete.[20]

13. Rather, economic principles show that the proposed transaction will give rise to:[21, 22]

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[13] See, for example, our first report, para 57.

[14] Our first report, paras 59-60, 56, 70 and 73-74; and our second report, para 40.

[15] Our first report, para 60; and our second report, para 41.

[16] We set out the relatively small quantum of expected cost savings in section 3.2.1.

[17] SOUI, paras 57.1 and 276.2 (chapeau).

[18] For example, a firm with constant marginal costs in a perfectly competitive market would be expected to pass through the entirety of a reduction in its marginal cost, while a monopoly with constant marginal costs would be expected to pass through 50 per cent of a reduction in its marginal cost. Indeed, with increasing marginal costs, the pass through under monopoly can exceed the pass through under perfect competition. See: Ritz, R, *Does competition increase pass-through?*, RAND Journal of Economics, 55(1), Spring 2004.

[19] We note that this sequence of anticipated changes to the pre-merger economic outcomes takes no account of the potential for a competitive response by Woolworths and/or other grocery retailers, the likely effect of which would be to reinforce the overall market effects.

[20] A lessening of competition, ie, an increase in the exercise of market power is typically characterised by prices increasing above (and thereby output falling below) the competitive level. See, for example: Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, pp 40-41; and ACCC, *Guidelines on misuse of market power*, August 2018, para 2.14.

[21] We note that this paragraph sets out the direction of the effect of the proposed transaction on competition, but the quantum of the change is expected to be relatively small, consistent with the relatively small quantum of expected cost savings set out in section 3.2.1.

[22] This is recognised by the Federal Trade Commission (FTC) (US). See paragraph 33.

a. an increase in the intensity of downstream competition between retailers (including the merged entity, Woolworths, and other retailers), leading to lower prices and higher output;

b. in the upstream, grocery acquisition markets:

   i. an increase in the intensity of competition between suppliers of grocery products; with

   ii. that increased intensity of competition given effect by two buyers that were previously three (among others), each competing to acquire a greater quantity of grocery products.

14. In our view, there are three important observations to be made in relation to the framework and conclusions set out in this section, ie:

a. first, the principal distinction between this analysis and a 'typical' merger involving some aggregation of buyers is that those buyers generally also compete in the downstream market – in which case:

   i. the observation at paragraph 6.a above that there is no loss of rivalry between the parties in the downstream, retail grocery market would not apply; and

   ii. the detrimental effect of this loss of rivalry in the downstream market would need to be compared to the mitigating effect of a reduction in input costs on downstream competition;

b. second, the conclusion set out at paragraph 13 above applies irrespective of the intensity of competition (and corresponding 'equilibrium position') between the parties, Woolworths and other competitors that prevails pre-merger; and

c. third, this same framework of reasoning (derived from unchanged retail market rivalry as between the parties) can be used to explain why the merged firm would retain the incentive to ensure optimal supplier investment.[23]

[23] For example, Inderst, R and Wey, C, *Buyer power and supplier incentives*, WZB discussion paper, No. SP II 2003-05, 2003, p 3, explains that 'consider[ing] a supplier's incentives to choose between different non-contractible strategies of production or process innovation… the formation of larger buyers should [in both instances] induce the supplier to choose strategies that increase total output and, by raising consumer surplus, possibly increase social welfare.'

3. Unilateral effects in acquisition markets

15. In this section, we:

    a. set out the appropriate economic framework within which to assess any potential lessening of competition arising from the proposed transaction;

    b. address each of the Commission's principal contended theories of harm; and

    c. explain that it is inappropriate to separate the effects of the proposed transaction as between the relevant upstream and downstream markets.

3.1 The bargaining framework is most appropriate

16. The Commission expresses its findings by reference to a bargaining framework, referring to the bilateral nature of grocery retailer negotiations and the presence of different trading terms across retailer-supplier relationships.[24] The Commission has suggested that a market or monopsony framework[25] – in which there is a single market price – may be more appropriate for some grocery products.[26]

17. We explain in our earlier reports that a bargaining framework tends to be the more appropriate model for reflecting relevant structural features of most upstream grocery supply and tends to be capable of predicting the observed outcomes of negotiations between retailers and suppliers more closely than the monopsony framework.[27]

18. In contrast to its agreement about the general applicability of the bargaining framework to this matter, many of the Commission's concerns appear to draw from other (less relevant) economic frameworks, being a monopsony framework as well as a conventional, downstream market framework. For example:

    a. a monopsony framework invites considerations as to changes in:

       i. prices or input volumes that are 'artificially suppressed'[28] or 'forced below the competitive level';[29] and

       ii. suppliers' ability and incentives to innovate,[30] ie, longer term negative consequences for output or quality;[31] and

[24] SOUI, para 118.

[25] The 'monopsony power' framework also refers to situations in which there are more than one buyer, eg, a market with an 'oligopsony' or even 'monopsonistic competition'. Consistent with our earlier reports, we use the term 'monopsony power' to refer to the ability of large buyers to profit by reducing the amount purchased below the competitive level that would otherwise apply when there are many sellers that, collectively, face increasing marginal costs of supply. See our first report, para 12.

[26] SOUI, para 119.

[27] See, for example, our first report, para 40; and our second report, para 6.

[28] SOUI, para 41.

[29] SOUI, para 42.1.

[30] SOUI, para 42.5.

[31] The Commission contends that a reduced ability of some suppliers to invest could give rise to 'effects such as reduced capacity, quality or innovation in the product market or markets in which the supplier is active'. SOUI, para 122.1.

b. a conventional (downstream) market framework invites considerations of the potential for reductions in choice or quality for retail consumers.[32]

19. The Commission's framework also involves a focus on several considerations that are not informative as to the likelihood of a substantial lessening of competition, such as:

a. the effects on particular competitors (suppliers), rather than changes to competition, ie, market outcomes across all suppliers and potential suppliers;[33] and

b. the implications of different potential allocations of surplus (unless there are short- or long-term output effects, which the Commission does not appear to have explicitly contended).

20. The Commission's assessment puts forward a range of 'categories of acquisition markets'.[34] We address these contended 'categories of acquisition markets' in section 3.4 below.

21. These 'categories' are not clearly defined markets and do not contain the relevant associated descriptions and analyses of the suppliers and potential suppliers within those relevant markets. However, such a market definition exercise is a necessary precursor to any finding of a likely substantial lessening of competition.[35]

22. Overall, the choice of economic framework is not, itself, determinative of the considerations that must apply in contending that a substantial lessening of competition is likely. Irrespective of the framework adopted, an assessment of competition must consider that the likelihood of any lessening of competition in an acquisition market arising will be affected (and potentially eliminated) by the corresponding implications for a buyer's ability to compete in the corresponding downstream market.[36] In other words, the question to be addressed is not the existence of a potential 'trade off' of competitive benefits in one market and harms in another, but that the incentives for competitive harm to arise in one market (ie, the upstream market) depend on the conditions in the other, ie, the parties' ability and incentive to procure and sell groceries in the downstream market.

23. A theory of harm as to a likely substantial lessening of competition in an acquisition market must therefore consider:

a. the definition of the relevant grocery acquisition product market(s);

b. the identification of the buyers and sellers present (and potential) in the relevant grocery acquisition product market(s);

c. how competition works as between those buyers and sellers in that market;

d. how things change, with and without the merger, ie, the effect on the competitive process of the aggregation of the two buyers, generally as evidenced by its likely effect on market outcomes, ie, prices and quality; and

e. the implications for changes in the acquisition market of prevailing conditions (and any change therein) in the accompanying retail grocery market – since groceries are acquired only for the purpose of on-sale in a corresponding retail market.

[32] SOUI, para 42.2.

[33] For example, Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 39 explains that '…competition policy is concerned with defending market competition in order to increase welfare, *not defending competitors* [emphasis added].' See also our second report, para 36.

[34] SOUI, table 2, pp 31-36.

[35] In contrast, a finding of no likely substantial lessening of competition is consistent with only a slight change in the balance of bargaining position that we identify in our first report.

[36] Our first report, paras 45-46.

24. Importantly, the competitive effect of the aggregation of buyers will be governed by the combination of:

    a. price and output effects in the acquisition market as a result of any strengthened buyer power in that market;

    b. the price and output effects in the retail market as a result of any strengthened ability and incentive for retailers to compete (derived from a reduction in input costs) in the corresponding downstream market; and

    c. any effect that the former has on the latter, and vice versa.

3.2 Commission's central theories of harm are unfounded

25. We agree with the Commission that competition leads to competitive prices, higher quality, variety and innovation[37] – this is a standard and uncontroversial economic conclusion.

26. It is important to recognise that the essential economic harm arising from a substantial lessening of competition occasioned by a merger between competing buyers is suppression of prices and output below the competitive level.[38] However, economic principles show that the proposed transaction will have the opposite effect, in both upstream and downstream grocery markets.[39] A reduced number of buyers may be relevant to an assessment of competition but cannot itself represent a harm to competition unless that important output condition is met.

27. In contrast, the Commission considers that a substantial lessening of competition arising from the proposed transaction would likely be 'accompanied by':[40]

    a. a transfer of surplus from grocery suppliers to the merged entity as a result of prices being forced below the competitive level;

    b. a reduction in choice or quality of groceries;

    c. exit by suppliers from an acquisition market;

    d. a reduction in the number of channels for suppliers, or a reduction in the number of opportunities suppliers have to pitch new ideas or products; and/or

    e. a reduction in grocery suppliers' ability and incentives to invest or innovate.

28. We address each of the contended harms cited by the Commission in the following sections.

3.2.1 A transfer of surplus does not amount to a lessening of competition

29. A transfer of surplus from suppliers to the merged entity is not itself harmful to competition, ie, a change in surplus does not inform the potential for rivalry, output or quality effects in the relevant markets. We set out in section 2 that the application of conventional economic principles to the facts of the proposed transaction shows that there will be no lessening of competition arising from the proposed transaction.

30. Further, the Commission's adverse view of the potential for any transfer of surplus presupposes that the market is currently sharing surplus in the 'correct' proportions. To the contrary, it is entirely

[37] SOUI, para 45.

[38] The Commission recognises the important output condition in its current guidelines, eg, 'Buyer market power is…the ability to profitably depress prices paid to suppliers to a level below the competitive price for a significant period of time such that the amount of input sold is reduced.' Commerce Commission, *Mergers and acquisitions guidelines*, May 2022, paras 4.2.

[39] See paragraph 13.

[40] SOUI, paras 33, 42 and 121.

possible that, in some grocery acquisition markets, an increase in buyer power works to counteract market power currently held by suppliers. Indeed, the Commission's invocation of the waterbed effect[41] must necessarily imply the existence of market power held by suppliers in those markets, because those suppliers must be able to 'give less and charge more' in order for the waterbed effect to arise. Similarly, concerns expressed by suppliers around 'cherry picking' of terms by the merged entity imply that those suppliers are presently exercising their bargaining or market power in respect of at least one of the two co-operatives.[42]

31. Indeed, some statements by suppliers appear to be expressing a concern that they will have to compete harder after the merger, eg:[43]

    a. a supplier contending that there will be 'some [suppliers] that win and some that get completely wiped out';

    b. suppliers being put 'under pressure' to 'offer it [the merged entity] the best terms';

    c. suppliers would be 'even more desperate' to hold onto their spots on shelves;

    d. that the merged entity would represent 'a lot of value and volume'; and

    e. that after the North Island Foodstuffs merger:

        i. negotiations 'often favoured the terms where there was the lowest cost'; and

        ii. 'while some suppliers benefitted [eg, had ranges extended], others lost out [eg, had less-competitive ranges reduced].'

32. These statements are consistent with the parties seeking to offer the most competitive, downstream retail position and with seeking to have the upstream market as competitive as possible.

33. That a transfer of surplus does not amount to a lessening of competition is also recognised by international competition bodies, such as the FTC, which explains that neither competition nor consumers are harmed:[44]

> …when the increased bargaining power of large buyers allows them to obtain lower input prices without decreasing overall input purchases. This bargaining power is procompetitive when it allows the buyer to reduce its costs and decrease prices to its customers.

Scale of any potential transfer of surplus is relatively small

34. We explain at paragraph 8.b that the parties expect that the merger will result in a small improvement in their relative bargaining position *vis a vis* some suppliers and, as such, may be able to achieve a reduction in the average price the merged entity pays to acquire groceries.

35. The parties have estimated that the total saving from these 'buying benefits' that is expected to be achieved over a six-year period is [REDACTED], which equates to just [REDACTED] of the parties' total expenditure on products over that period.[45] In other words, the parties expect only a very small reduction in the prices paid to suppliers, in comparison to the parties' costs.

[41] SOUI, para 261.2.

[42] SOUI, para 153.

[43] SOUI, paras 152-154, 193, 195.

[44] FTC, *In the matter of Caremark Rx, Inc./AdvancePCS*, File no. 031 0239, p 2.

[45] We understand that this [REDACTED]. See Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, para 64.

36. It follows that – notwithstanding our explanation that a transfer of surplus does not amount to a lessening of competition – even the largest possible effect of the proposed merger in any market could not reasonably be described as 'substantial'.[46]

3.2.2 Reduction in choice or quality or exit of suppliers is not presumptively anticompetitive

37. The Commission's concerns regarding a reduction in quality or choice for retail customers are misdirected. The Commission contends that the:[47]

> …consolidation [of FSNI and FSSI] with the Proposed Merger could impact the pace and development of new product innovation for some suppliers, resulting in reduced consumer choice and quality of grocery products.

38. We explain at paragraph 14.c that, since no downstream rivalry between the parties is lost, the merged firm retains the incentive to ensure optimal supplier investment, ie, so it can compete downstream with Woolworths and other rivals.

39. Further, we explain in our second report that:[48]

    a. the proposed transaction can give rise to an increase in the ability and incentive for investment by suppliers because the merged entity will offer a single new product development (NPD) cycle and process, rather than two separate and misaligned cycles; and

    b. the incentives for suppliers to invest efficiently are unlikely to be harmed by the proposed transaction, and may be enhanced.

40. Finally, a reduction in choice or quality, in and of itself, carries no implication of a reduction in competition or consumer welfare. Consumers are unlikely to be harmed if, for example:[49]

    a. a reduction in quality is accompanied by a sufficiently large price reduction, ie, such that the quality-adjusted price also falls; or

    b. a reduction in choice is supported by sufficiently substitutable products being already available or newly introduced, or if shelf-space has been reallocated to a better overall consumer offering.

41. The category review processes undertaken by the parties strongly evidence this focus, ie, the parties seek to optimise the balance of attractive consumer offering and allowing the parties to earn a commercial return on shelf space.[50]

42. Similarly, the parties will retain a strong, unchanged incentive to ensure the price, quality, range and service (PQRS) dimensions of their grocery retail offering best meet consumer needs. Consistent with the parties' category review process, exit (or reduction in range) by one supplier will correspond with entry by a different (either new or expanded) supplier that will improve the merged entity's PQRS offering.

43. Accordingly, even if some suppliers did exit as a result of the proposed transaction,[51] this can be presumed to represent a 'harm to competitors' and not a harm to competition.[52] In other words,

[46] We assume that the distribution of the total savings by relevant antitrust market is similarly small and could not reasonably be described as 'substantial'.

[47] SOUI, para 69.7.

[48] Our second report, paras 27-29.

[49] These observations are consistent with, for example, the parties' category review processes. See, for example: our second report, para 33.

[50] See: Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, para 137-140.

[51] We consider this to be highly unlikely, including because the quantum of the effect is likely to be very small – see section 3.2.1.

[52] See footnote 33.

supplier exit would precisely represent the process of competition between suppliers to be the most efficient and to offer the best product for ultimately meeting consumer demand.

44. By consequence of downstream market conditions, the merged entity is incentivised to *maximise* competition in the acquisition market, rather than to facilitate or risk exit by efficient upstream suppliers, because exit by efficient upstream suppliers could establish or enhance market power held by the remaining suppliers.[53]

3.2.3 Contentions as to a 'reduction in the number of channels or opportunities' are erroneous

45. The Commission is incorrect to cite harms arising from a reduction in the number of channels or opportunities to pitch for suppliers, because:

    a. despite the merged entity consolidating two, formerly geographically separate buyers in many grocery acquisition markets, it will purchase the same or a greater quantity than FSNI and FSSI (in combination) pre-merger;[54] accordingly

    b. it is misconceived to cite a reduction in the number of 'opportunities to pitch' when the value of those channels/opportunities to pitch have increased by at least a commensurate, offsetting amount (and, indeed, the ability to offer to only one region or island will remain); and hence

    c. unless the increased buyer concentration is likely to result in a reduced quantity of groceries sold (which it is not) and thereby below-market prices, it cannot be said there will be any detriment to competition.

3.2.4 Merger will not reduce the ability and incentive for efficient supplier investment

46. The Commission's contention that the proposed transaction would lead to a reduction in suppliers' ability and incentive to invest and innovate is not supported by mainstream economic theory.[55] Rather, we explain at paragraph 39 that the proposed transaction would give rise to better opportunities for investment, and at paragraph 38 that the parties' incentives to ensure optimal supplier investment will remain unchanged.

47. It follows that the merger will not result in a reduction in the ability or incentive for efficient supplier investment, including because it would be contrary to the merged entity's interests for this to occur.

3.2.5 Other Commission contentions as to harms are also unfounded

48. The Commission further contends that:

    a. rivalry among buyers is in '…consumers' long-term interests as the competitive process plays out over time'[56] – consistent with our explanation of the applicable principles in section 2 the economic reasoning underpinning this contention is unclear, and we disagree as to its veracity;

    b. it is not required to establish links between effects in acquisition markets and impacts on consumers[57] – on the contrary, the economic relationship between acquisition and retail markets necessitates that an assessment of the effect on competition jointly consider the effects in those markets, ie:

[53] The Commission appears to partially recognise this point in the SOUI, ie, '…we acknowledge that the merged entity would like competitive supply…'. SOUI, para 130.

[54] See paragraph 12.

[55] Our second report, para 21. For more detail regarding efficient supplier investment, see our second report, section 2.1.2.

[56] SOUI, para 48.

[57] SOUI, para 49.

i. acquisition market effects can only arise as a result of incentives that are also governed by the corresponding retail market effects; and

ii. if retail market competition is unchanged, the incentive to undertake anticompetitive conduct in the acquisition market would be eliminated when assessing how that conduct would affect the corresponding retail market.

49. In our first report, we explain that major national suppliers to FSNI and FSSI are:[58]

> …likely to have strong bargaining positions, potentially derived from the strength of their brands or supplier market power…In many instances, these major national suppliers are likely to represent 'must have' suppliers that Foodstuffs would seek to ensure availability of in order to compete most effectively at the retail level…These suppliers are likely to have significant (countervailing) supplier power over buyers.

50. We understand that some major international suppliers establish a presence in New Zealand by way of:

a. local production facilities – for example, Kraft Heinz manufactures Wattie's and some Heinz and McCain products domestically[59] while Nestle produces Maggi and Milo domestically; and/or

b. an agency arrangement, which may grant the agent exclusive right over the supplier's products in New Zealand – for example, DKSH New Zealand represents Lindt[60] and Diplomat represents Proctor & Gamble brands, such as Gilette.[61]

51. In respect of agency arrangements on behalf of major international suppliers, the correct way of characterising the bargaining relationship between Foodstuffs and the supplier/agent is that any outside options or countervailing supplier power (or supplier market power) are best understood as those of the *supplier*, not the agent. For example, the outside options in such a relationship would not be limited to that agent negotiating with New Zealand buyers of that supplier's products, but also by reference to the supplier having the ability to deploy its resources (and capital) in other markets.

52. Similarly, the outside options for a major international supplier with some local production facilities would also include that supplier having the ability to deploy its resources (and capital) in other markets.

53. In other words, the effect of the proposed transaction on those major international suppliers is unlikely to be different from the effect on the remaining major international suppliers (which, in itself, is not expected to be material).

54. Some domestic suppliers also engage agencies to manage the relationship with retailers, such as:

a. Whittaker's, which engages Twin Agencies;[62] and

b. Fix & Fogg, which engages James Crisp.[63]

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[58] Our first report, paras 56 and 58.

[59] For example, see: Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendix 10.

[60] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendix 16.

[61] Diplomat, https://www.diplomat-global.com/nz/the-brands/, accessed 12 August 2024.

[62] Twin Agencies, https://www.twinagencies.co.nz/whittakers, accessed 9 August 2024. Twin Agencies also represents a number of domestic brands, such as Barker's, L'affare, Hubbards, Farrah's, ecostore, RJ's, Heartland and Robert Harris.

[63] James Crisp, https://jamescrisp.co.nz/what-we-do/brand-representation/, accessed 9 August 2024. James Crisp also represents a number of international brands in New Zealand, such as Ocean Spray, Best Foods, Barilla, Sun Rice, Jif, Choysa, Lipson, Domestos and Colman's.

55. In relation to these agency arrangements, in most cases we would expect that the existence of such arrangements to act to countervail bargaining power held by the parties, including by engaging specialist negotiators.

56. Following the proposed transaction, it is conceivable that the [REDACTED].

3.2.6 Scale as a barrier to entry

57. The Commission contends that the merged entity's 'increased buyer power would allow it to…reduce retail prices and raise the minimum required scale of rival grocery retailers to compete effectively'.[64] We disagree for two reasons.

58. First, we explain in our second report that [REDACTED]. In other words, it is unlikely that a change in the scale of the merged entity's buying would affect the prospect of entry.

59. Second, it is difficult to understand how, if this barrier were to be material, the parties can presently compete at all with Woolworths and other national grocery retailers. In other words, if an island-based entity (each of the co-operatives, separately) can presently compete effectively with a national retailer (and others), it is not clear why this ability would not persist into the future, with the merger. On this inconsistency, we also note that [REDACTED].

3.3 Separation of upstream and downstream markets is artificial

60. We agree with the Commission that it is essential to focus on the 'competitive process' and 'independent rivalry' when assessing the potential effects of a merger.[65] However, it is not economically valid to assess a potential substantial lessening of competition within an acquisition market by reference solely to changes in that market (ie, reduced buyer rivalry), because:

    a. the incentive applying in relation to the economic effect of a change in buyer power in an acquisition market (and so the likelihood of an effect generally arising) depends upon the corresponding downstream market;

    b. the oligopsony problem of suppressed volumes and prices cannot be sustained if competitive conditions in the retail market imply that some portion of the input cost reduction will be passed through to retail consumers, thereby mitigating:

        i. the volume reduction caused by the acquisition market price suppression – if retail prices also fall, the acquisition market quantity effect will be mitigated/eliminated; and

        ii. the incentive to drive acquisition market prices and output below the competitive level, because to do so involves sacrificing profitable sales in the retail market (without an expectation of a future, offsetting increase in profit).

61. Further, the economic implications of this particular proposed transaction are rare, because there is no existing rivalry between the parties in the retail grocery market, and so there can be no change in rivalry in that market.[66] By consequence of these circumstances:

    a. any change in rivalry is limited to grocery acquisition markets; and

    b. any incentive for volume and price suppression in an upstream, grocery acquisition market must take account of the opposing incentive to increase profits by expanding sales in the downstream, retail grocery market.

[64] SOUI, para 277.

[65] SOUI, para 37.

[66] See paragraph 6.a.

62. The benefit to consumers from protection of the competitive process therefore does not apply without qualification to acquisition markets. In the circumstance of no change to the intensity of retail competition, as is expected under the proposed transaction:[67]

    a. consumers will benefit from more effective grocery acquisition arrangements; and

    b. consumers will be harmed if more effective grocery acquisition arrangements are *prevented* from being realised.

63. We agree in principle with the Commission's statement that the need to assess mergers by reference to a potential substantial lessening of competition applies '…to acquisition markets as it does to selling markets.'[68] However, a critical difference between these two contexts that appears to be recognised but not applied by the Commission is that the assessment of competitive effects in an acquisition market must account for the possibility that the merged entity has no incentive to behave in a way that harms competition because of the characteristics of the corresponding selling market.[69]

3.4 Assessment of specific acquisition markets

64. In the SOUI, the Commerce Commission set out various 'categories of acquisition markets' that it considers as 'likely to be affected' by the proposed transaction.[70] Drawing upon these categories and the category review processes undertaken by them, the parties have prepared 'deep dive' analyses to assess the dynamics at hand in respect of products in each of those categories.[71]

65. In our view, the category review processes already undertaken by the parties are likely to reflect the market dynamics and bilateral arrangements that take place between the parties and their suppliers in those categories. In particular, the 'deep dive' analyses show that:

    a. the starting point for the category review processes and the parties' engagement with suppliers more generally is to maximise each party's competitiveness at the retail level, ie, by reference to consumer demand and meeting customer 'need states';[72]

    b. the de-ranging of products generally arises as a result of:

        i. that product selling poorly, relative to other products in the category (while ensuring that customer 'need states' are met) – for example:

            1. FSNI de-ranged [REDACTED] because these products were performing poorly relative to other highly substitutable products[73] and comprised a small proportion of FSNI's sales in this product segment; and

            2. FSSI reduced [REDACTED], due to high duplication within need states;[74]

[67] See paragraph 6.a.

[68] SOUI, para 38.

[69] The Commission recognises that '…there are commercial dependencies between selling markets and acquisition markets that are relevant to [its] assessment.' SOUI, para 32.

[70] SOUI, para 111 and table 2, pages 31-36.

[71] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendices 2 to 21.

[72] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, paras 137-138.

[73] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendix 8. [REDACTED].

[74] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendix 12.

ii. long-term trends in consumer demand – for example, a decrease in post-pandemic demand required FSNI to de-range a number of [REDACTED] for range rationalisation purposes;[75]

iii. high costs relative to other products in the category, such as FSNI's de-ranging of [REDACTED], which was supplied by [REDACTED] and imported from overseas, for which the reduction had no material effect on the category as a whole or suppliers therein;[76] and

c. the de-ranging of one product is associated with either the ranging of a new product (from a new or existing supplier) from within the same category or the expansion of shelf space for other category products that better reflect customer 'need states'.

66. These analyses reinforce the higher-level analysis that we set out in sections 2 and 3 above, ie:

a. the parties' upstream demands to acquire groceries are dependent on consumer demand for groceries in the downstream markets;[77]

b. consumers are unlikely to be harmed if a reduction in choice in one product category is supported by sufficiently substitutable products being already available or newly introduced, or if shelf-space has been reallocated to a better overall consumer offering;[78]

c. any supplier exit can be presumed to represent the process of competition between suppliers to be the most efficient and to offer the best product for ultimately meeting consumer demand;[79] and

d. the parties are receptive to new product development when this will be met by consumer demand for such innovation.[80]

67. The analyses also show that the bilateral relationships between the parties and their suppliers are generally best characterised by the bargaining framework, and that the outworking of the merger will not be a reduction in purchases from the upstream input markets. We explain in section 3.2.1 above and in our earlier reports that a transfer of surplus alone cannot amount to a lessening of competition.

3.4.1 Fresh produce

68. In our first report, we assess how the proposed transaction could affect:[81]

> …fresh product markets [which include fresh produce], for which changing circumstances, primarily on the supply side, imply the existence of a more dynamic market environment.

69. We also explain that:[82]

> …the dynamic market environment that characterises fresh grocery product may lead to occasions where there is insufficient supply on a regional or nationwide basis to satisfy the typical demand in that area for a fresh product.

[75] For example, prior to the category review, FSNI ranged [REDACTED] products at New World, for which just [REDACTED] represented [REDACTED] of sales. FSNI reduced its range and optimised products based on banner, for example [REDACTED]. On the other hand, continued demand increases for [REDACTED] meant that FSNI retained a broader range of products (including price points, customer choice and pack size) as necessary to reflect need states by banner.

[76] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Response to statement of unresolved issues*, 13 August 2024, appendix 4.

[77] See paragraph 7.a.

[78] See paragraph 40.b.

[79] See paragraph 43.

[80] See paragraph 38.

[81] Our first report, paras 76 and 78.

[82] Our first report, paras 92-93.

> …
>
> Notwithstanding, in these limited circumstances, it may be that FSNI and FSSI seek to acquire the same, limited product, in situations where some customer demand must be curtailed to address the insufficiency of supply…The net effect [of the proposed transaction] may be that, with the transaction, the prices paid to suppliers during these limited periods may be slightly lower – although, this outcome is far from assured because other grocery retailers and other customers (eg, exports, food manufacturers) may win a greater share of the supply that is available for their own customers. In any case, even during these periods, Foodstuffs' incentive to compete in downstream retail markets imply that its most effective competitive strategy would be to pass on those slightly lower prices to its own customers.

70. The proposed transaction is unlikely to cause a lessening of competition even in these (limited in number and in duration) circumstances, because:

a. there remains a high degree of competition between buyers for fresh produce, ie, including the merged party, Woolworths, Costco, individual grocery retail stores (such as individual Foodstuffs stores, Farro Fresh and international food stores such as Tai Ping) and specialty fruit and vegetable stores;

b. exports (and, for some products, imports) continue play an important role in determining the outside options available to suppliers (and buyers);

c. fresh produce wholesalers, such as T&G Fresh, MG Fresh Produce Group and Fresh Direct (and other wholesalers) are also important buyers of produce from suppliers;[83] and

d. the merged party's unchanged downstream incentives[84] imply that it would seek to acquire the same amount of produce, ie, total market demand will remain unchanged with the proposed transaction and it is likely that market outcomes in these circumstances (in terms of both price and quantity) will be similar with and without the merger.

[83] See: our first report, para 84.

[84] See section 2.

4. Coordinated effects in retail markets

71. In this section, we set out the reasoning for our opinions that there is limited vulnerability to coordination in the retail grocery market, and that coordination would continue to be impracticable with the proposed transaction.

72. To successfully coordinate pricing (ie, to collude), firms in an industry must solve two interrelated problems – first, they must reach an agreement in relation to collusive prices, the 'coordination problem', and second, given the incentive to cheat, firms must also enforce the agreement through potential punishments, the 'enforcement problem'. [85] In the case of tacit coordination, firms must do so without communicating explicitly.

73. First, in the retail grocery market, the parties and Woolworths are highly unlikely to be able to reach a collusive agreement over national prices without communicating, both with and without the merger. The retailers each sell many thousands of different products, differentiate their offerings on the basis of price, quality, range and service (PQRS) through their respective store banners and have a range of priorities when setting prices. This makes the coordination problem intractable because it means a collusive agreement would need to, without communicating:

    a. establish a set of mutually acceptable price differentials over all or a selected set of products, where the firms face different demand conditions and optimal prices; and

    b. define acceptable conduct in relation to non-price dimensions of competition.

74. Further, the likelihood of the parties and Woolworths reaching a consensus over coordinated national prices is materially undermined by the asymmetry between their respective corporate structures, which will not change with the merger. Foodstuffs' co-operative structure means that individual store owners have an incentive to set optimal prices to meet local consumer demand, given the competitive conditions specific to their local market and their respective store banner. In contrast, Woolworths' corporate structure means it has an incentive to set prices to maximise profits over all of its stores across New Zealand, collectively. This means finding a set of mutually acceptable national prices is highly improbable.

75. Second, even if an agreement could be reached, it is very unlikely that coordination between the parties and Woolworths could be enforced and sustained for related reasons to those given above. Since the retailers operate under differentiated store banners, they each have an incentive to deviate from a collusive agreement over national prices by adjusting non-price dimensions of their product offering. Such cheating is not readily detectable, particularly through price monitoring alone.

76. Coordination would also be difficult to sustain because Woolworths is unlikely to have a credible threat to punish deviations by individual Foodstuffs stores by consequence of its national pricing strategy, which means it would need to forgo collusive profits across all of its stores to impose a punishment.

77. In the material below, we set out:

    a. a framework for assessing coordinated effects; and

    b. that coordination is unlikely with and without the merger, because:

        i. there is no substantial change in factors affecting coordination with and without the merger;

[85] Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 308.

ii. it is likely to be very difficult for grocery retailers to reach an agreement to coordinate; and

iii. grocery retailers are unlikely to be able to enforce and sustain any collusive agreement.

4.1 Framework for assessing coordinated effects

78. A merger may give rise to coordinated effects where it increases the likelihood that a number of dominant firms in the market will reach (or strengthen) a collusive agreement, either tacitly or explicitly, to enhance their profits by sustaining prices above the competitive level.[86]

79. The Commission states that it considers coordinated effects in the grocery market following the proposed merger could arise by means of the merged entity and Woolworths reaching a tacit agreement on the level of some national retail prices.[87] Accordingly, we focus our analysis on the potential for tacit collusion over national prices.

80. Price coordination involves firms agreeing to set prices above the competitive level that would prevail if firms were acting independently, to jointly increase their profits.[88] Since firms have an incentive to undercut their rivals whenever prices rise above the competitive level, for coordination to be profitable, firms must trust that their competitors will also raise prices to match.

81. Coordination can only take place if:[89]

a. the firms involved are *able* to reach a collusive agreement – being the phenomenon by which firms achieve a common understanding, whether derived tacitly or explicitly, of how they each should conduct themselves and potentially allocate the benefits from collusion – also known as the 'coordination problem';[90]

b. the firms have an *incentive* to adhere to an agreement, rather than deviate from it — this requires that:[91]

i. firms are able to monitor and detect whether their rivals are adhering to the agreement;

ii. those firms that do not adhere to the agreement (ie, they 'cheat' or 'deviate') expect to incur a cost (ie, a 'punishment') – say, in the form of lower prices for a period – that is greater than the benefit from cheating on the agreement;[92] and

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[86] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 93 - 94.

[87] SOUI, para 337.

[88] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 94. We note that, in general, collusion may also be on the basis of the level of output, quality of goods or over other related aspects of competition, such as dividing market shares.

[89] Davies, C, and Wainscoat, L, *Not quite a cartel: applying the new concerted practices prohibition,* Competition & Consumer Law Journal, 25, 2017, p 203. Stigler identified in 1964 that for collusion to occur the parties need to agree on prices, monitor behaviour and punish defectors. See: Stigler, G J, *A theory of oligopoly*, Journal of Political Economy, 72, 1, 1964, pp 45-46. Isaac and Plott explained in 1981 that firms had to solve two problems to collude: how to initiate a collusive arrangement and how to implement it. See: Green, E J, Marshall, R C and Marx, L M, *Tacit collusion in oligopoly*, in Blair, R D and Sokol, D D (eds), *The Oxford handbook of international antitrust economics, volume 2*, Oxford University Press, Oxford, December 2014, p 3.

[90] Hay, G A, *Facilitating practices: the ethyl case (1984)*, Cornell Law School Legal Studies Research Paper Series, p 14. Kovacic, W E et al, *Plus factors and agreement in antitrust law*, Michigan Law Review, 110, 3, 2011, p 408; and Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 93.

[91] Hay, G A, *Facilitating practices: the ethyl case (1984)*, Cornell Law School Legal Studies Research Paper Series, p 15.

[92] This requires that it is in firm's interest to administer the punishment when necessary, and that the punishment is sufficiently bad for the firm being punished. See, for example: Baker, J, *Two Sherman Act section 1 dilemmas: parallel pricing, the oligopoly problem, and contemporary economic theory*, The Antitrust Bulletin, 1993, p 158; and Green, E J, Marshall, R C and Marx, L M, *Tacit collusion in oligopoly*, in Blair, R D and Sokol, D D (eds), *The Oxford handbook of international antitrust economics, volume 2*, Oxford University Press, Oxford, December 2014, p 8.

c. the firms outside the agreement are not able to supply sufficiently large quantities so as to undermine it.[93]

82. Firms need to solve the coordination problem before price coordination can take place. Fabra and Motta explain firms need first to agree on the strategy they will follow, along with other dimensions of their conduct, stating:[94]

> …the fact that firms could sustain collusion does not mean that they actually succeed in doing so. For the market outcome to be collusive, it is also necessary that firms solve a *coordination problem*, i.e., they have to agree on which strategy to follow, which price they want to set or which level of output they want to produce, how they will adapt it to changes in the market environment, among many other dimensions of the agreement.

83. Even when firms can communicate, reaching an agreement can be difficult, since all prices between the fully competitive outcome and the monopoly outcome that maximises industry profits are potential collusive equilibria.[95] Firms are likely to have conflicting interests as to which equilibrium to play (eg, prices to set) where they are not symmetric, eg, if they have different costs.[96] Firms with lower marginal costs would prefer lower collusive prices than those that firms with higher marginal costs would optimally like to sustain.[97]

84. Such an agreement is significantly harder to reach in the case of tacit coordination, where firms do not explicitly communicate to agree on collusive prices or conduct.[98] If firms cannot communicate, they may select a price that is not jointly optimal and may be difficult to change.[99] These mistakes may be very costly for individual firms, eg, causing them to lose market share or a trigger price war with rivals.[100]

85. For coordination to be enforceable and sustainable after a collusive agreement has been established, firms must ensure that there are no incentives to deviate from the agreement – this is known as the 'incentive' or 'enforcement problem'.[101] We explain above that this means firms need to be able to monitor the extent of adherence to an agreement and credibly retaliate by punishing those that cheat on the agreement.[102]

86. The ability to inflict a strong punishment depends on the balance of immediate gains available to an individual firm by consequence of undercutting its rivals (ie, deviating from the agreement) and future

[93] Carlton, D W, and Perloff, J M, *Modern Industrial Organisation*, 4th edition, Pearson Education Limited, Harlow, Essex, 2015, p 155.

[94] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 93.

[95] See, for example: Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 311; and Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 93, footnote 7.

[96] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 93, footnote 7; and Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, p 36.

[97] Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, p 36.

[98] Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 141.

[99] Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 141.

[100] Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 141.

[101] Baker, J, *Two Sherman Act section 1 dilemmas: parallel pricing, the oligopoly problem, and contemporary economic theory*, The Antitrust Bulletin, 1993, p 152; and Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 93.

[102] Stigler, G J, *A theory of oligopoly*, Journal of Political Economy, 72, 1, 1964, pp 44 and 46.

collusive profits foregone.[103] A punishment must also be credible, meaning it is in the interest of the firm threatening the punishment to carry through with its threat.[104]

87. As such, a merger can increase the likelihood of coordination if it increases collusive profits, reduces the profits available through deviation, or increases the severity or credibility of punishment.[105]

88. Firms coordinating their behaviour face added complexity when responding to demand shocks or market changes. Rivals may struggle to differentiate between deviations from collusion and responses to market conditions, and reaching a consensus on how to address these changes can be challenging, especially under tacit coordination.

4.1.1 Factors that facilitate coordination

89. There are a number of factors that can influence how likely it is that firms will be able to agree on and sustain a collusive strategy in a market. A factor facilitates collusion if it reduces the incentives to deviate from a collusive agreement or enables firms to reach an agreement by coordinating on a collusive equilibrium.[106] These factors include:[107]

   a. supply-side factors, such as the number of firms in a market, barriers to entry, excess capacity, size and cost asymmetries, multi-market contact and product homogeneity or differentiation;

   b. demand-side factors, such as increasing or decreasing demand over time, demand shocks and countervailing buyer power;

   c. market transparency (ie, public prices), communication and information exchange between market participants; and

   d. pricing rules, such as the existence of most-favoured nations clauses or price matching promises.

90. The analysis of factors affecting the likelihood of coordination is often complicated because such factors may point in different directions within a market and there are no clear rules in the economics literature specifying how such factors should be weighted in those circumstances.[108] Accordingly, an assessment of whether a merger will be likely to result in or strengthen coordination will depend on which factors are most important in the case at hand.[109]

91. In the material below, we address the key factors influencing coordination in the retail grocery market, including the Commission's analysis of their effect and how they are expected to change with the merger.

4.2 Coordination is unlikely with and without the merger

92. In our opinion, the retail grocery market is not currently vulnerable to coordination and is unlikely to be with the merger. In this section we:

[103] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 95-96.

[104] Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 329.

[105] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 96.

[106] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, p 96.

[107] See, for example: Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, pp 340 – 348; and Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 96-104; and Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, pp 142-159.

[108] Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 251.

[109] Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, p 251.

a. set out how the key factors that may facilitate coordination change with and without the merger;

b. establish that it will be very difficult for grocery retailers to reach a collusive agreement, because, both with and without the merger:

   i. the price setting processes employed by the parties and Woolworths makes coordination highly impracticable in the absence of explicit communication;

   ii. the complexity of the products sold by grocery retailers, including the number of products and differentiation between banners, makes the coordination problem intractable;

   iii. [REDACTED], despite there being an increase to two national 'major grocery retailers' with the merger; and

   iv. the merged parties and Woolworths will remain fundamentally asymmetric due to their different corporate structures;

c. set out that coordination is no more likely to be sustained by consequence of the merger, because, both with and without the merger:

   i. the ability for the parties and Woolworths to detect and punish deviation on a collusive agreement is limited; and

   ii. there is no change to the risk that a third party would reduce the stability of a collusive equilibrium (which is unlikely to exist, in any case).

4.2.1 No substantial change in factors facilitating coordination with the merger

93. In this section, we set out whether the features of retail grocery markets that may make them vulnerable to coordination would change by consequence of the merger.

94. As it relates to the ability to agree on and sustain coordination:

a. without the merger:

   i. FSNI and FSSI are two separate, co-operatives of individual store owners that present a single national bricks-and-mortar and online retail grocery offering through common brands and compete with Woolworths and other retailers in non-overlapping geographic markets, ie, in the North and South islands, respectively;

   ii. FSNI, FSSI and Woolworths stores compete in numerous local retail grocery markets,[110] along with other retailers selling grocery products;

   iii. the respective Foodstuffs and Woolworths banners sell 'many thousands of products'[111] and compete on different aspects of price and non-price competition, including price, quality, range and service level;[112]

   iv. in relation to price setting:

[110] SOUI, para 336.2.

[111] SOUI, para 365.

[112] SOUI, para 368.

1. FSNI sets recommended retail prices (RRPs) and FSSI sets 'shelf prices' for their respective member stores,[113] which [REDACTED].[114] FSNI and FSSI are capable of setting national prices together;[115] and

2. Woolworths operates a national business model where pricing is almost entirely consistent nationwide, with the exception of fresh produce, which may vary between the North and South islands.[116, 117] However, Woolworths would also be capable of setting regional or local prices; and

v. in most instances, FSSI and FSNI negotiate with suppliers separately and have separate corporate costs;

b. with the merger:

i. FSNI and FSSI are one merged co-operative of individual store owners competing with Woolworths in the national, regional and local retail grocery markets;

ii. there is no change to competition between Foodstuffs, Woolworths and other competitor stores in local retail grocery markets;

iii. there is no change to the number of products offered or the differentiation of the respective banners of Foodstuffs and Woolworths;

iv. in relation to price setting:

1. Foodstuffs will continue to set RRPs or shelf prices [REDACTED] and be capable of setting national prices,[118] although it may be slightly more likely that Foodstuffs sets national RRPs or shelf prices if there will be fewer administrative barriers to doing so; and

2. we assume that Woolworths will continue to set consistent prices nationwide and be capable of setting regional and local prices; and

v. FSSI and FSNI will negotiate with suppliers as one entity and share corporate costs, which may slightly reduce its input costs - see sections 2 and 3.2.1.

95. The key difference in these factors is that Foodstuffs will become more comparable in size to Woolworths on a national level, ie, its co-operative members will comprise a *national* retailer (although we note that the parties already present a single national bricks-and-mortar and online offering to consumers). However, the merged entity will [REDACTED].

96. There is also a potential change in cost asymmetries between Foodstuffs and Woolworths due to the potential for a small reduction in grocery acquisition costs for the merged entity. However, whether costs become more or less symmetric with the merger depends on the difference in costs between FSSI and FSNI and Woolworths without the merger (matters that neither party knows about the other).

[113] SOUI, para 355.1.

[114] SOUI, para 355.6.

[115] SOUI, para 403.

[116] SOUI, para 356.1.

[117] Notwithstanding the information provided in its submission, Woolworths has subsequently indicated it may be moving towards a local pricing strategy. See: Newsroom, Milne, J, *Big supermarket revamp lays groundwork for postcode price wars*, 7 August 2024, available at https://newsroom.co.nz/2024/08/07/big-supermarket-revamp-lays-groundwork-for-postcode-price-wars/, accessed 9 August 2024. In this section, we address the Commission's contention that the proposed transaction could increase the likelihood of coordination over national prices. We address Woolworths' potential move to localised pricing in section 4.2.4.

[118] SOUI, para 401.

97. The Commission states that it does not have any clear evidence of existing coordination in the grocery market.[119] We agree that there is no evidence that FSSI and FSNI and Woolworths have been able to reach and/or sustain a collusive agreement without the merger, and we do not expect these markets to be currently vulnerable to coordination, including for the reasons set out below.

4.2.2 A collusive agreement between grocery retailers would be intractable

98. In the material below, we consider how likely it is that the parties and Woolworths would be able to coordinate their behaviour, both with and without the merger.

99. We explain in section 4.1 above that firms must be able to reach a collusive agreement without explicitly communicating for tacit coordination to take place – they must be able to solve the ‘coordination problem’.

100. Further, for a collusive agreement to be sustained, deviation must be able to be detected and punished. This necessarily requires the collusive agreement, and therefore deviation from it, to be well defined and understood by the parties involved.

101. In a simple model of price coordination, this would involve firms agreeing on a collusive price somewhere between the (commonly known) competitive price and monopoly price of a single, homogenous product, where any deviation below the agreed price would constitute cheating on the agreement and trigger retaliation via punishment.[120] When market conditions, such as consumer preferences, change, the firms would need to agree on a new collusive price.[121]

102. Even in this simple model, when coordination is tacit rather than explicit, firms may find it difficult to arrive at a collusive equilibrium.[122]

103. In contrast, in retail grocery markets, the bases of any collusive agreement would be much more complex and would likely need to involve tacit agreement in relation to:

    a. the product(s) on which prices will be coordinated;

    b. the prices or price differentials for those selected products, taking account of variation in quality and other aspects of product and brand differentiation;

    c. what constitutes a price deviation and how it will be measured – for example, a change in one price or a change in the average price across a basket of goods;

    d. what constitutes deviation from an agreement beyond a change in price (ie, on QRS factors) – for example, changes in price with or without a corresponding change in product quality, expanding a product range to include a lower priced item and so on; and

    e. how changes in market conditions can be responded to without being mistaken for deviation and triggering a punishment phase.

[119] SOUI para 388. The Commission also noted that it did not find any evidence of accommodating behaviour in its market study in 2022, see: Commerce Commission, *Market study into the retail grocery sector*, Final report, 8 March 2022, para 5.154.

[120] See, for example: Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, pp 139-141.

[121] See, for example: Motta, M, *Competition policy: theory and practice*, Cambridge University Press, New York, 2009, pp 139-141.

[122] See paragraph 84.

104. The Commission considers whether the merged entity and Woolworths could *reach* a tacit agreement and notes that this would be more likely where:[123]

    a. there is a metric that the merged entity and Woolworths can coordinate on such as price, volumes, or quality;

    b. the products that are being coordinated on are not too complex;

    c. few rival grocery retailers operate nationally; and

    d. there is symmetry between rival grocery retailers.

105. We agree with the Commission that these factors are important indicators of whether a tacit agreement would be possible in the retail grocery market. In our opinion, these factors indicate that the parties and Woolworths would not be likely to reach a tacit agreement over national prices, both with and without the merger.

106. We explain below that the parties and Woolworths are unlikely to be able to reach a collusive agreement over national prices, particularly due to the multi-faceted price setting process and complexity of the products offered by the retailers, including the large number of goods sold and differentiation between banners on PQRS factors. In our opinion, there is no compelling evidence indicating that an agreement between the firms would be more likely with the merger or even possible at all.

Retailers unlikely to be able to agree on mutually acceptable prices without communicating

107. The Commission states that national grocery retail prices are the most likely metric on which the parties and Woolworths could coordinate because there are features of the price setting process that may support such coordination.[124]

108. However, the Commission does not demonstrate how the price setting processes adopted by FSNI, FSSI and Woolworths could facilitate the likelihood of coordination (ie, reaching a shared understanding of the terms of a collusive agreement), other than noting that the firms frequently monitor and respond to each other's prices – which is entirely consistent with the firms competing – as one element of the multi-faceted process.[125]

109. In our opinion, the Commission's contention that the price setting process may support coordination is undermined by a lack of thorough consideration in relation to what a collusive price agreement would entail in the retail grocery market, which we set out in paragraph 103 above, and therefore, the significant complexity involved in solving the coordination problem or reaching a tacit agreement.

110. Reaching an agreement of this kind without communicating is likely to be challenging and made more difficult by the multi-faceted price setting processes employed by the retailers, which we explain below.

[123] SOUI, para 353. The Commission also considers that reaching an agreement is more likely where there are grocery retailers than can play a facilitating role but says this factor 'does not seem relevant' in the context of the grocery retailers.

[124] SOUI, para 354.

[125] SOUI, para 357.3

111. The Commission explains that FSSI, FSNI and Woolworths consider a range of key factors when setting prices for a given product across their stores, including:[126]

    a. [REDACTED], including in relation to competitors – for example, the parties [REDACTED],[127] and Woolworths [REDACTED];[128]

    b. [REDACTED];

    c. [REDACTED];

    d. [REDACTED];

    e. for the parties, [REDACTED];[129] and

    f. the outcomes of internal review processes – for example, FSNI [REDACTED][130] and FSSI [REDACTED].[131]

112. [REDACTED].[132] [REDACTED].[133]

113. Given the price setting approaches of the parties and Woolworths,[134] it is apparent that coordination between the grocery retailers would require agreement over a set of price differentials between products offered at the various banner stores, rather than agreement over a single collusive price for each given product.

114. By way of illustration, an agreement may need to allow the price for, say, one kilogram of chicken to be five per cent higher at Woolworths than Pak'nSAVE and three per cent lower at Woolworths than New World, or expressed in absolute terms, say, $1.50 higher at Woolworths than Pak'nSAVE and $1 lower at Woolworths than New World.

115. Further, price differentials would need to be established for each product over which coordination was to take place individually, since the parties' [REDACTED] [REDACTED].[135]

116. Even before considering how such products would be identified, this is likely to be highly impracticable in the absence of explicit communication.

117. Adding to the complexity, the set of collusive prices must be acceptable to both retailers for an agreement to be reached – ie, both retailers should consider the outcome a collusive equilibrium. Given the multi-faceted, dynamic nature of the price setting process for the parties and Woolworths, the different demand conditions facing each banner by consequence of its differentiated brand positioning, and since each retailer does not have full information in relation to its competitors' costs and demand functions, it is again likely to be highly impracticable that the firms will reach a well-defined agreement without communicating.

[126] SOUI, paras 355 – 356.

[127] SOUI, para 355.1.

[128] SOUI, para 356.2.

[129] SOUI, paras 355.2.7, 355.4, 355.5 and table 5.

[130] SOUI, paras 355.3.

[131] SOUI, paras 355.5

[132] SOUI, para 355.4, Table 5.

[133] SOUI, para 355.4.

[134] Ie, the differentiated pricing strategies (ie, brand positioning) employed by Woolworths, Pak'nSAVE and New World, including the use of [REDACTED].

[135] SOUI, para 355.4.

118. By way of example, FSSI and [REDACTED].[136] A price increase (above the competitive level, such as by way of coordination) in one variety of a product offered by a store will impose an externality on other varieties of the same or similar products sold in that store or by competitors, altering the residual demand for those substitutes, all else equal. The effect of such price changes on substitute products available at Woolworths, Pak'nSAVE, or New World may vary due to differences in product ranges and customer preferences.[137] As such, grocery retailers may differ in their estimation of jointly profit-enhancing collusive prices for a given product.

119. To illustrate, say Woolworths increases the price of frozen chicken by 10 percent, and Pak'nSAVE subsequently finds it optimal to follow with a 5 percent price rise on an equivalent product. Woolworths may then revert to its competitive price if it believes this combination of higher prices will see it lose sales to Pak'nSAVE. Since the retailers have asymmetric information in relation to both costs and demand, they may not be able to find a set of prices acceptable to both.

120. The Commission proposes that the merged entity and Woolworths could achieve coordination by testing retail price increases and quickly reverting if the rival firm does not follow.[138] However, the complexity of finding acceptable price differentials between banners for various products is unlikely to be resolved through this testing process.

121. Further, even where a set of collusive prices could be established at some point in time, it is likely to be very difficult for the firms to respond to evolving market conditions by adjusting prices over time without such conduct being mistaken for deviation and triggering retaliation. Coordination on the basis of an average basket of goods is also highly improbable for this reason.

122. Accordingly, in our opinion, it is very unlikely that the parties and Woolworths would be able to reach a tacit agreement on national retail grocery prices and maintain such an agreement as conditions change over time. These dynamics apply both with and without the merger.

Complexity of products sold by grocery retailers makes tacit coordination intractable

123. We explain above that coordination would be difficult because firms would need to agree on a set of price differentials that change over time. A further and related complicating factor is the number and differentiation of products offered by the parties and Woolworths in retail grocery markets.

124. The Commission acknowledges this complexity, explaining:

    a. the retailers sell many thousands of products, each subject to different demand conditions and promotional activity, which would make reaching and monitoring an agreement difficult;[139]

    b. FSNI and FSSI may not sell consistent product ranges, which would make it difficult for Woolworths to compare its prices with the merged entity;[140]

    c. coordination over the average price of a basket of goods would be difficult to monitor because it would be hard to distinguish when price differences were due to cheating or differences in calculation methods;[141]

[136] SOUI, paras 355.2 and 356.1.

[137] For example, customers shopping at low-cost retailers may be more price sensitive, represented by a higher elasticity of demand. An increase in the price of a branded product may cause a larger proportion of price sensitive customers to switch to a budget product, which may provide lower margins to the retailer.

[138] SOUI, para 357.3.

[139] SOUI, para 365.

[140] SOUI, para 367. There is a high degree of alignment in ranging between FSNI and FSSI – see, for example, SOUI, para 93. However, there is also a degree of local ranging, which means that, at present (and with the merger), there is heterogeneity between product ranges from store to store (including within each cooperative).

[141] SOUI, para 366.

d. the retailers provide differentiated product offerings through their respective banners (ie, Pak'nSAVE, New World, Four Square, Woolworths, SuperValue and FreshChoice), which compete on price and non-price dimensions of competition (ie, quality, range and service (QRS)), implying that they would need to reach an understanding on relative grocery prices adjusted for non-price dimensions of competition;[142]

e. [REDACTED], which may increase the difficulty to reach and sustain a coordinated agreement because it requires establishing multiple price differentials;[143] and

f. there may only be a subset of products that are suitable for coordination, which adds complexity because the retailers would need to have a shared understanding of which products were subject to coordination and would each have an incentive to lower prices for products outside the group.[144]

125. We agree with the Commission on each of the points above, which are supported by the economics literature.

126. In particular, the differentiation of banners both complicates and undermines the likelihood of the firms reaching an agreement and maintaining coordination because it affects the incentives for cheating, the ability of firms to retaliate and the nature of how firms can cheat.[145]

127. The presence of non-price competition and differentiation undermines the likelihood firms will be able to reach a collusive agreement because it expands the number of variables on which firms must agree.[146] This makes it harder and more costly for retailers to reach a well-defined collusive agreement, required to maintain coordination.

128. Relatedly, differentiation means that firms can cheat not only by reducing their prices or increasing their output, but also in a vast number of ways that are not easily detected, such as by improving the quality of products or adjusting the product range, or by means of loyalty benefits or individualised promotions.[147] Increasing the number of ways to cheat reduces the likelihood of agreement. By way of example, the parties and Woolworths would need to agree whether changes in customer service in each of their stores would constitute deviating from a collusive agreement over prices, and how this could be monitored.

129. As we explain above, differentiation between the banners also means that the retailers would need to agree on a set of collusive price differentials, rather than a single price for any given product.

130. The vast number of products offered by grocery retailers exacerbates the coordination problem. To reach a collusive agreement, the retailers would first need to identify which products would be subject to coordination, a challenging task given the vast array of options available and [REDACTED].

131. Even once a subset of products is selected, defining what constitutes deviation or cheating becomes complex. There is no unique customer 'basket' and customers make purchasing decisions based on the overall store offering, shopping for groceries for different purposes at different times.[148]

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[142] SOUI, para 368.

[143] SOUI, para 369.

[144] SOUI, para 371.

[145] Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 344.

[146] Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 345. We note that differentiation also influences the stability of collusion by decreasing the benefit of cheating by undercutting rivals while also decreasing the effectiveness of punishment since customers are less price sensitive. The resolution of this ambiguity depends on the nature of differentiation and demand.

[147] Church, J and Ware R, *Industrial organisation: A strategic approach*, Irwin McGraw-Hill, Boston, 2000, p 345.

[148] The Commission refers to three 'main categories of shopping missions', although grocery retailers identify a wider range of 'shopping missions'. See: Commerce Commission, *Market study into the retail grocery sector*, Final report, 8 March 2022, paras 4.10-4.11.

Consequently, a firm could potentially undermine the collusive agreement by lowering prices on products outside the agreed-upon subset, making it difficult to detect and address such deviations.

132. In our opinion, the ability of the parties and Woolworths to reach a well-defined collusive agreement without communicating given the level of brand differentiation and number of products over which coordination could take place is highly unlikely, even fanciful. These factors do not change with the merger, implying coordination will remain intractable.

Foodstuffs will remain a co-operative of individual stores each with a profit maximising incentive

133. The Commission contends that it may be easier for the parties and Woolworths to reach a tacit understanding to coordinate national prices with the merger because there will be two major grocery retailers operating nationally.[149]

134. However, it notes that the ability of the firms to reach a coordinated outcome is complicated by the ability of individual Foodstuffs stores [REDACTED], which means individual stores may have an incentive to undercut a coordinated national price and Woolworths would find it hard to react to deviations while maintaining a national pricing strategy.[150]

135. In our opinion, the co-operative structure and ability of individual Foodstuffs stores [REDACTED] materially undermines price coordination both with and without the merger.

136. Ivaldi et al explain that it is more difficult to reach a consensus on a coordinated outcome the larger the number of parties involved, particularly when coordination is based only on a tacit understanding of the conduct required to maintain the collusive outcome.[151]

137. While the merger will result in two national retailers, the co-operative structure of the Foodstuffs business means that there are many more than two interested parties to consider when setting coordinated prices, particularly with each individual Foodstuffs store facing different local market conditions and therefore optimal profit maximising prices.

138. In paragraphs 144 to 146 and 167 to 172 below, we explain in more detail why individual Foodstuffs stores would likely have an incentive to deviate from collusive national prices, and therefore why coordination would not be likely or sustainable. It follows that it is unlikely the parties and Woolworths would be able to reach an agreement to coordinate on national prices both with and without the merger.

Significant asymmetry in corporate structure is likely to prevent a collusive agreement

139. The Commission explains that symmetry between firms 'increases the likelihood of coordination because the incentives to coordinate are more likely to be aligned'.[152] It notes that there are differences and similarities between the parties and Woolworths and considers symmetry between them on the basis of their respective:[153]

    a. national footprints and market shares;

    b. corporate structures – ie, co-operative (the parties) versus corporate, trans-Tasman (Woolworths) models; and

    c. cost bases.

[149] SOUI, para 358.

[150] SOUI, para 358-359.

[151] Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, p 12.

[152] SOUI, para 373.

[153] SOUI, para 375.

140. Generally, a smaller firm has a greater incentive to deviate because it has more to gain and less to lose from cheating.[154] A firm with lower costs has more incentive to deviate because its rival is less able to impose a credible threat of punishment for deviation.[155]

141. We agree with the Commission that, in general, greater symmetry increases the likelihood of coordination because it balances (or aligns) the incentives to collude, or conversely, to deviate, between the firms.[156] In relation to the likelihood of reaching an agreement, symmetrical firms will also have similar views in relation to the conduct required for coordination, including the selection of optimal collusive prices, such that reaching a consensus may be easier.[157]

142. Therefore, potential changes in symmetry should be considered in the context of whether such changes will materially affect the firms' incentives to collude or deviate, whether these incentives become more aligned by consequence of the merger and the likelihood of finding a mutually acceptable collusive equilibrium.

143. In our opinion, although the merged entity will have a national footprint, there remains significant asymmetry between the parties (separately or as a merged entity) and Woolworths by consequence of their divergent corporate structures, materially undermining the retailers' incentives and ability to reach a consensus over national prices. This will not change by consequence of the merger.

144. While FSNI and FSSI will become a single national retailer with the merger, [REDACTED].

145. For example, where an individual Foodstuffs store faces greater competitive pressures in its local market, including from third-party competitors such as the Warehouse and Costco, and/or more price-sensitive customers, it may find it more profitable to lower prices below a nationally collusive level to capture market share and increase its own profits.

146. The Commission's quantitative analysis shows that [REDACTED] [REDACTED] and [REDACTED] [REDACTED] when set alongside average net profit margins earned by supermarkets.[158]

147. [REDACTED], Woolworths will continue to be a corporate entity with the incentive and ability to set prices to maximise profits over all of its stores operating in local markets across New Zealand, collectively. Given that Woolworths currently aims to set a national price for its products,[159] we can assume it is profit-maximising to do so.

148. One implication of nationally consistent pricing is that Woolworths may accept lower profits in some stores in order to earn even higher profits in others – an outcome that is unlikely to be compatible with the co-operative model and therefore unlikely to be adopted by the parties, as required for coordination over national prices, both with and without the merger.

149. This divergence in the level at which profits are maximised and therefore prices are set – local versus national – limits the feasibility of the parties and Woolworths agreeing on a collusive equilibrium or sustaining coordination if an agreement could be reached. We explain the implications of this

[154] See, for example: Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 97-99.

[155] See, for example: Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, pp 36-37.

[156] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 97-98.

[157] Fabra, N and Motta, M, *Assessing coordinated effects in merger cases*, in Corchon, L C and Marini, M A (eds), *Handbook of game theory and industrial organization, Volume II: Applications*, Edward Elgar Publishing Limited, Cheltenham, UK, 2018, pp 97-98.

[158] SOUI, paras 360 and 361.

[159] SOUI, para 356.1. As noted at footnote 117, Woolworths has indicated it may be moving towards a more localised pricing, which we address in section 4.2.4 below.

asymmetry on the credibility of Woolworths' threat to punish deviations in more detail in paragraphs 167 to 172 below.

150. Relatedly, the Commission suggests that some grocery products may be more suitable for coordination where the [REDACTED].[160] However, the lack of variation in prices for these products observed by the Commission occurred at a time when there was no evidence of coordination taking place.[161] In contrast, if coordination was to take place on a national level, individual Foodstuffs stores would have an incentive to [REDACTED] for any products where it was profitable to do so (as explained above). As such, a current lack of variation around the RRP or shelf price for some product categories does not imply a store would not offer discounts in the future to deviate from a collusive agreement and maximise its profits.

151. In relation to cost asymmetry, the parties and Woolworths are likely to have different cost functions by consequence of their corporate structures and differentiated banners, both with and without the merger. Further, such cost functions are held as private information by each firm and individual store owner. In relation to reaching a collusive agreement, this means that each firm will be uncertain about its rival's ability to punish deviations and therefore likely more wary of entering an agreement.

152. Further, [REDACTED].[162] Economic theory indicates that low cost firms have a higher incentive to deviate because they have less to fear from retaliation since a higher cost firm will not be able to induce a substantial profit loss without imposing an even larger burden on itself.[163] This implies that Woolworths is unlikely to be willing to enter a collusive agreement with the merged entity.

4.2.3 Coordination is unlikely to be sustained with and without the merger

153. In the material below, we consider the sustainability of coordination in the retail grocery market with and without the merger.

154. We explain in section 4.1 above that coordination will only be sustainable after a collusive agreement is reached if:

    a. there are no (or insufficient) incentives for firms to deviate from the agreement – the *incentive or enforcement problem*; and

    b. external parties cannot disrupt coordination by offering lower prices over a sufficient quantity of the product in question – ie, there is *external stability*.

155. Consistent with this framework, the Commission considers whether the merged entity and Woolworths could sustain a tacit agreement because:[164]

    a. the firms would be able to detect and punish deviation from a collusive agreement; and

    b. the agreement would not be at risk of being undermined by third parties.

156. It also considers whether the sustainability of coordination would be greater by consequence of the merger.[165]

157. In our opinion, coordination between the parties and Woolworths is very unlikely to be able to be sustained. Differentiation between the retailers' through and within their respective banners means

[160] SOUI, para 370.

[161] For example, we explain at paragraph 97 above that the Commission has not found any clear evidence of coordination.

[162] SOUI, para 376.2.

[163] Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, pp 36-37.

[164] SOUI, para 378.

[165] SOUI, paras 392-405.

deviation may occur on the basis of non-price dimensions of competition, which is not detectable through price monitoring alone. Additionally, the retailers are unlikely to have credible and effective punishment strategies because differentiation reduces the losses they can impose on one another and Woolworths is unlikely to have a credible threat to punish deviations by individual Foodstuffs stores by consequence of its national pricing strategy. We set out our reasons for this opinion below.

Ability to detect and punish deviation on any collusive agreement is limited

158. We explain in section 4.1 above that for coordination to be sustained, punishment for deviation must be sufficiently unprofitable, including that:

    a. firms must be able to monitor and detect cheating; and

    b. the expected cost of punishment must be greater than the gain from deviating, including because the threat of punishment is credible.

159. The Commission contends that price transparency in the grocery market enables the parties and Woolworths to monitor prices and 'quickly detect large scale deviations from a coordinated agreement'.[166] However, it acknowledges that 'it may be difficult to know whether a retail price change for an individual product is consistent with a coordinated agreement'.[167]

160. In our opinion, while price transparency may enable the retailers to identify movements in price, it is likely to be much more complicated to detect cheating on an agreement.

161. We explain in section 4.2.2 above that it is likely to be very difficult for the parties and Woolworths to reach a well-defined collusive agreement, specifying collusive conduct in relation to price and non-price dimensions, in light of the number of products offered in retail grocery markets, differentiation between the respective banners, and the need to respond to different demand conditions and evolving customer preferences. Notably, non-price competition expands the number of ways firms can cheat beyond decreasing prices.

162. It follows that the ability for the parties and Woolworths to detect deviation from a collusive agreement is likely to require more than price monitoring alone. Accordingly, it is not clear that the firms are able to monitor and detect cheating with sufficient precision to enforce and sustain coordination in the retail grocery market. These factors do not change with the merger.

163. The Commission also contends that the merged entity and Woolworths are likely to have 'credible and effective strategies' to punish deviations, including initiating a period of low grocery prices to reduce a rival's profits, [REDACTED].[168]

164. We disagree that the retailers will have credible and effective punishment strategies for two reasons.

165. First, the parties and Woolworths provide differentiated product offerings to appeal to different segments of the retail grocery market. Differentiation limits the severity of imposing a price war because customers may be less likely to switch to a rival by consequence of a reduction in price (for example because they value a higher level of customer service) and therefore limits firms' abilities to punish potential deviations.[169] The Commission does not appear to consider the implications of non-price competition on the effectiveness of punishment strategies.

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[166] SOUI, para 381.

[167] SOUI, para 381.

[168] SOUI, para 382.

[169] Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, pp 45-46. We note that differentiation may also decrease the gains from cheating, such that the effect of differentiation on the stability of collusion is ambiguous. The resolution of this ambiguity depends on the nature of differentiation and demand.

166. Relatedly, we assume that the parties and Woolworths' differentiated banners also have different cost structures, which reduces the credibility of the threat of punishment in some cases. In particular, higher cost firms are less able to induce a substantial profit loss for lower cost firms without dropping prices to a level that would impose a significant burden on themselves, rendering the threat of punishment not credible.[170]

167. Second, individual Foodstuffs stores [REDACTED],[171] while Woolworths is currently committed to setting prices on a national basis.[172] This disrupts the stability of a potential collusive equilibrium over national retail grocery prices because it reduces the credibility and effectiveness of the punishment Woolworths can impose on the parties.

168. We explain in paragraphs 144 to 146 above that individual Foodstuffs store owners have an incentive to maximise their profits by competing with rivals in their local market, [REDACTED].[173]

169. In contrast, Woolworths has an incentive to set prices that will maximise profits from all of its stores operating in local markets across New Zealand, collectively. It currently does this by setting national prices.[174]

170. Even if the parties and Woolworths could theoretically reach an agreement over national prices, the inherent asymmetry in their incentives would undermine the credibility of Woolworths' ability to impose a punishment. Specifically, Woolworths would find it costly to punish a single Foodstuffs store for deviating from the collusive agreement, since doing so would cause it to forgo collusive profits across all of its other stores where it maintains national pricing.

171. The Commission acknowledges these dynamics, stating:[175]

> Individual FSNI/FSSI stores may have an incentive to deviate and to undercut any coordinated national retail price. Individual FSNI/FSSI stores may find it profitable to do so if Woolworths wishes to maintain its strategy of having the same prices across all its stores. This would make it difficult for Woolworths to react to deviations on any coordinated agreement by individual FSNI or FSSI stores.

172. Understanding that Woolworths is unlikely to respond, an individual Foodstuffs store will have an incentive to [REDACTED] to increase profits and capture market share in its local market. Since all individual Foodstuffs stores face this incentive to cheat, coordination would be likely to break down at the national level.

Coordination may be disrupted by third parties with and without the merger

173. In relation to external stability, the Commission contends that:[176]

    a. it is unlikely that any new competitors will enter the national grocery market in the near term; and

    b. coordination on certain products may be disrupted by retailers such as The Warehouse and Costco, which may require the merged entity and Woolworths to agree on different 'price levels in different areas for the same product'.

[170] Ivaldi, M et al, *The economics of tacit collusion*, Final report for DG Competition, European Commission, March 2003, p 37.

[171] SOUI, paras 360-361.

[172] SOUI, para 356.1.

[173] FSNI and FSSI are co-operatives of members that operate individual grocery stores. See SOUI, para 18.

[174] [REDACTED], see: SOUI para 356.1.

[175] SOUI, para 359.

[176] SOUI, para 385.

174. We agree that coordination would be disrupted by other grocery retailers, including those identified by the Commission and additional rivals not classified as ‘one-stop-shops’, which further complicates the ability to reach and sustain a collusive agreement.

175. The Commission’s suggestion that the merged entity and Woolworths could agree on different prices for the same products in different local markets adds a further layer of complexity to an already intractable coordination problem, and would require Woolworths to move away from national pricing. Although this is possible (both with and without the merger), no merger-specific factors suggest that Woolworths would have a changed incentive to do so.

176. It also moves the Commission’s analysis away from a focus on the potential for coordination on a national basis to coordination on a local basis, which the parties and Woolworths are already capable of without the merger. As such, there is no change to these factors with the merger, therefore there is no change in the external stability of coordination in the retail grocery market.

4.2.4 Woolworths’ potential move to local pricing reduces likelihood of coordination

177. We understand that Woolworths may be moving to give more emphasis to localise pricing, notwithstanding the information provided in its submissions.[177]

178. To the extent this may be so, coordination between the parties and Woolworths on national prices is even less likely, since such coordination requires the retailers each to set prices on a national basis.

179. The asymmetry between Foodstuffs and Woolworths' corporate structures and its effect on the level at which the profit maximising incentive applies (ie, at the local store level for Foodstuffs, and at the national level for Woolworths) is also unchanged, both by consequence of the merger and any shift towards more localised pricing by Woolworths.

180. We explain in section 4.2.2 above that individual Foodstuffs stores are unlikely to have an incentive to maintain national prices given their individual profit maximising incentives, particularly if such prices were set above the competitive level in their local market through tacit coordination at the national level. On the other hand, Woolworths may have an incentive to set a nationally consistent price to maximise profits across all of its stores. Alternatively, it may have an incentive to maximise its profits by setting a greater proportion of its prices by reference local conditions.

181. Since the likelihood of increased coordination arising by consequence of the proposed transaction requires both parties to have an incentive to set and maintain national prices, in our opinion, the retail grocery market is not vulnerable to such coordination.

182. Further, a move by Woolworths from national pricing to give more emphasis to local pricing means that the proposed transaction could not give rise to any increase in coordination at a local level, ie, it cannot change the factors affecting the likelihood of sustainable coordination in local retail grocery markets. We explain in section 4.2.1 above that Woolworths has an ability to price locally both with and without the merger, but has previously chosen not to do so, which we presume to be profit maximising.

[177] See, for example: Newsroom, Milne, J, *Big supermarket revamp lays groundwork for postcode price wars*, 7 August 2024, available at https://newsroom.co.nz/2024/08/07/big-supermarket-revamp-lays-groundwork-for-postcode-price-wars/, accessed 9 August 2024.

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