

Submission for Commission's Grocery Market Study – 23 November 2021

1. Introduction and overview

- 1.1 This submission – which is mine alone as I act for none of the parties – focusses on design aspects of operational and structural separation remedies. That flows into material relevant to other remedies. It is based particularly on the Commission's draft report as to remedies, and the discussion at the conference on operational and structural remedies. I am doing this because of my very close involvement in the design and, subsequently, implementation issues, as to operational and then structural separation in telecommunications. Additionally, it is based on my experience of the effects of structural separation in electricity.
- 1.2 My observations are therefore neutral in approach, neither for nor against, unless I see clear problems or benefits. Stakeholders, whether producers, the two chains, their retail competitors including potential new entrants, consumers, the regulator and Government, have considerable ability to effectively influence the outcomes. And to game things too, to their benefit outside the public sector parties. This applies across the spectrum of remedies as well.
- 1.3 The regulatory design must of course be particularly careful, to avoid unexpected negative consequences. The Commission (and policy people at MBIE) are well attuned to these considerations, and that shows in the very good overview of remedies generally in the draft report.
- 1.4 **However, the big takeaway is that, for any separation option, the devil is in the detail.** There are considerable complexities, necessary carve outs for specific scenarios, and a need for crystal ball gazing. At one level, separation in this context is quite simple even though, here, unlike telecommunications, there are upstream and downstream material effects. Split the wholesale business unit out, operationally or structurally. But there will be a tangle to work through. Jagged lines not straight lines. And the jagged lines can be gamed.
- 1.5 The draft report is decidedly high level on these issues, and the discussion by stakeholders at the conference even more so. This is not a criticism, for the Commission has an immense task of which remedies are only one aspect, and it is hard to get into detail on remedies until the problem to be solved is clearly identified.
- 1.6 I note this as, on the basis of the analysis seen so far, the Commission is a long way from being able to definitively propose specific remedies to Government. It would be unwise to identify and define remedies absent further detail put into a discussion paper, followed by submissions. This might be done either by the Commission or MBIE.
- 1.7 Having noted that, high level regulatory design in principle should not be unduly bogged down in early stages with the inevitable detail.
- 1.8 I will start with inevitable outcomes, and then turn to some other issues. A key one is the potential for expansion and entry in currently unforeseeable areas. I give a very good example from recent Chorus experience, pointing to caution as to separation. Separated Chorus is facing remarkable and unexpected market

conditions from wireless competitors, never expected when the separation decision was made.

2. Operational separation is not a workable option

- 2.1 I will start with what I see as four inevitable outcomes. There is little point in the two chains arguing for them and ultimately they – in my view certainly - won't be accepted. The chains have pushed relevant points but to me they were arguing points that would never be accepted, ultimately.
- 2.2 My aim here is to help focus on the real issues including that the supermarkets focus on truly workable solutions from their points of view, as do the other stakeholders. All stakeholders have ample issues and benefits to run strongly outside these points
- 2.3 First, Telecom's operational separation failed and it will fail too in a grocery market context. That reflects similar failures overseas. I consider that this can be stated so categorically given the evidence internationally and domestically.
- 2.4 The fundamental problem is that, no matter how strong the construct of the separation, such as strong and high walls, and strong financial incentives to wholesale unit managers that are aligned with reducing the negative effects of the vertical integration, the overall interests of the company are too powerful. They will trump theoretical constructs. It is unworkable.
- 2.5 The Commission has plenty of evidence in this area and can obtain more too, such as from the independent oversight parties for the Telecom operational separation. A public example of this is [here](#), a matter in which I was closely involved acting for Kordia and CallPlus (now Vocus). This was a prime example of the broader interests of the listed company overriding the well-intentioned barriers of operational separation. The settlement, although substantial, did little to remedy the wider harms.
- 2.6 While the operationally separated company can game things, it is also possible that in the long run, this remedy is not good for that company either. That would need close analysis. Ultimately, for example, Telecom moved to structural separation (now Chorus and Spark), although driven by the shareholder value of the two separated listed companies being higher than the single listed companies. As Mr Quin notes, there was a voluntary aspect to the structural separation of Telecom.

3. Structural separation but same owners

- 3.1 Now to my second inevitable conclusion. I was surprised to see the Commission noting at the conference that (with additions in square brackets):¹ *"The key difference between structural separation [in this context, vertically] and divestment [in this context, horizontally] is that under divestment that structurally separated business would be sold to different owners."*
- 3.2 There are two problems with this. First it is not correct, as the Chorus and Telecom demerger shows.
- 3.3 Second, retention of ownership of the two "structurally separated" companies will fail, for the same reasons as operational separation will fail. This is really more like an operational separation. The holding company (whether listed or

¹ Day 6 Transcript page 5

unlisted) has exactly the same incentives: to maximise shareholder value for the ultimate shareholders. And that means that the boards and management of each separated subsidiary has exactly the same incentives. If there are market problems this will not solve them, even if operational separation-lookalike constructs are established.

4. Line of business restrictions are inevitable

- 4.1 To my third inevitable point. Structural separation will only work if the two chains are precluded from re-entering in wholesale. Just like line of business restrictions on lines companies and Chorus as to retail operations, the incentives for the retail supermarket chains to re-enter wholesale are very strong. And the barriers to entry are relatively low too compared to the benefit, although involving bricks and mortar etc. The two structurally separated wholesale units will be side-lined and quickly become unviable unless entry and expansion by others has been positively achieved: an unlikely scenario before the re-entry into wholesale.
- 4.2 The incentives to re-enter wholesale are shown by Mr Quinn's point that wholesale and retail are bundled as there are strong reasons to do so for the companies. Of course, vertical integration like that can bring considerable efficiencies and thus benefits to consumers all things equal. One of the issues will be whether the benefits of separation outweigh the detriments such as losing vertical integration efficiencies.

5. Having two bottlenecks instead of one is not a reason to avoid structural separation

- 5.1 Chorus – at least when separated out – was a monopoly bottleneck. Mr Quinn correctly notes that there is no monopoly bottleneck here. He says therefore that structural separation is not necessary.
- 5.2 The same applies in electricity. While there are multiple lines companies, they are all monopolies within their own territorial footprints.
- 5.3 However, conceptually, bottlenecks created in a duopoly context are just as susceptible and appropriate for structural separation as monopoly bottlenecks. A duopoly, due to coordinated effects, causes market failure nearly as much as monopolies. I think it is inevitable that the regulatory designers will not see that as a stumbling block.

6. Crystal ball gazing

- 6.1 To me this is one of the hardest yet most important areas.
- 6.2 It is well illustrated by the following. When Chorus and Telecom demerged, Chorus was truly the monopoly bottleneck via the fibre and copper local access network, at least where it got UFB funding. Yes, there was some competition particularly from mobile and fixed wireless operators, but this was decidedly limited.
- 6.3 Fast forward to the last year or three. Chorus now faces considerable competition, especially over mobile networks as to data and voice fixed line local access. Telcos, particularly Spark, are completely by-passing Chorus to provide local access to customers via wireless over their existing mobile infrastructure. This is for fixed line voice and standard internet users not big data users such as gamers. This is strong competition, being made even

stronger as mobile and fixed wireless squeeze a lot more capacity out of frequency with 5G, new towers, etc. With existing towers. Backhaul, systems, and frequency, barriers to entry are very low. This is added to by specialist companies specialising in fixed wireless access.

- 6.4 This level of entry and expansion would not have been forecast in 2012 yet only a few years later, the landscape has changed.
- 6.5 What entry and expansion is possible in grocery that would avoid the need for separation?
- 6.6 It may be that the Commission would decide that specialist competitors (the Costcos and the Moore Wilsons) do not provide adequate competition. This is illustrated by the NZME and Stuff clearance application, where competition to main stream providers (eg the Herald) by specialist providers such as NBR was discounted as to relevance.
- 6.7 But what of a new online entrant following an Amazon- type of operation. With low cost of entry into New Zealand, Amazon has provided huge competition to high-cost-of-entry/expansion bricks and mortar bookseller.
- 6.8 But it has been slow to enter the non-books business in New Zealand, given higher cost of entry etc. As to grocery, the supply chain for perishables creates greater problems.
- 6.9 And, assuming the draft report to be correct for present purposes, the problem remains in the wholesale market if there is no separation. The Amazon look-alike will face high wholesale prices.
- 6.10 Which brings us back to that part of the issues to be sorted.
- 6.11 Additionally, structural separation would not per se solve for the upstream problem. The two separated wholesale operations, all things equal, have the same incentives to tacitly collude vis-à-vis upstream suppliers, unaffected by disentangling.

7. Multiple regulatory design issues

- 7.1 The numerous pages of operational and then structural separation constructs for Spark and Chorus shows how detailed and multi-faceted the issues are, with opportunity for all to seek better outcomes from their points of view.

8. Be careful what you wish for!

- 8.1 The vertical chains of which grocery retail form part have multiple dimensions, and regulatory design faces the risk of unintended consequences.
- 8.2 And does the introduction of a third retail competitor really improve things for consumers sufficient to outweigh the detriments of regulatory action? That third competitor faces largely the same incentives to tacitly collude as does a monopoly all things equal.