



COMMERCE COMMISSION

Decision Nos. 606 & 607

Determination pursuant to the Commerce Act 1986 in the matter of applications for clearance of business acquisitions involving:

FOODSTUFFS (AUCKLAND) LIMITED, FOODSTUFFS (WELLINGTON) CO-OPERATIVE SOCIETY LIMITED, AND FOODSTUFFS SOUTH ISLAND LIMITED; and (separately) WOOLWORTHS LIMITED

and

THE WAREHOUSE GROUP LIMITED

- The Commission:** Paula Rebstock
David Caygill
Peter JM Taylor
Denese Bates QC
- Summary of Application:** The acquisition by the three Foodstuffs co-operatives and the acquisition by Woolworths Limited to acquire up to 100% of the ordinary shares in, or assets of, The Warehouse Group Limited.
- Determination:** Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline to give a clearance for the proposed acquisitions.
- Date of Determination:** 8 June 2007

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EXECUTIVE SUMMARY

Introduction

- E1. The Commerce Commission (Commission) received separate applications from Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-operative Society Limited, and Foodstuffs South Island Limited, (collectively Foodstuffs) and (separately) Woolworths Limited (Woolworths) seeking clearances to acquire The Warehouse Group Limited (The Warehouse). The issue for the Commission is whether it is satisfied that either of the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in any market. The Commission has prepared one set of reasons for its decisions declining these applications because the issues raised by both applications are similar.
- E2. The Commission must assess whether there is a real and substantial risk that there will be more than a minimal lessening of competition.¹ The Commission compares two situations: one with the acquisition proceeding (the factual), and one without the acquisition (the counterfactual). The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in a market between these two situations.
- E3. The Commission has declined the applications as it is not satisfied that the acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in a number of local supermarket markets.

Background

- E4. These Foodstuffs entities are regionally based cooperatives. Supermarkets under the Pak'n Save and New World are owned and operated by cooperative members, and operate throughout the country. Cooperative members also operate convenience stores. At the wholesale level, Foodstuffs distributes groceries throughout New Zealand.
- E5. Woolworths is an Australian-based company that acquired Progressive Enterprises Limited (Progressive) in 2005. It operates throughout New Zealand, 150 supermarket stores directly, operating under the Foodtown, Countdown and Woolworths banners, as well as coordinating an additional 48 franchise supermarket stores operating under the Fresh Choice and Super Value banners..
- E6. The Warehouse operates throughout New Zealand some 85 stores that sell general merchandise, toys, apparel and a range of other products, plus 43 stationery stores. It has an extensive distribution network to service its stores.
- E7. In 2002, the markets for supermarket retailing concentrated into two competing operators when Progressive purchased Woolworths NZ. Until recently, consumers' choice of supermarkets has been limited to one or other of the businesses controlled by Foodstuffs or Woolworths. In the larger population centres, consumers may have the choice of stores of both groups, but in lower population areas there may only be a banner of one group represented.

¹ *Air New Zealand & Qantas Airways Ltd v Commerce Commission (No. 6)* (2004) 11 TCLR 347; *Commerce Commission v New Zealand Bus Limited* (2006) 11 TCLR 679; *Fisher & Paykel Limited v Commerce Commission* [1996] 2 NZLR 731; *Port Nelson Limited v Commerce Commission* [1996] 3 NZLR 554.

- E8. In 2006, The Warehouse introduced the supercentre concept to New Zealand at Mt Wellington (Sylvia Park) and Whangarei. Modelled on supercentres or hypermarkets operating overseas, the Warehouse Extra stores provide shoppers with the convenience of purchasing general merchandise, apparel, and a wide range of groceries and food items commonly found in supermarkets in the one store. The Warehouse intends to run its Extra format for some time to see if it will succeed, modifying the format as necessary to fit New Zealand conditions. If successful, it will roll out further supercentre stores. It also has plans to convert other existing stores, or to construct new stores in other locations. The next “Extra” store is due to open in Te Rapa (Hamilton) in late 2007.
- E9. The addition of the Warehouse Extra stores provides, and would in the future provide, consumers in those localities with a third choice of an independently owned supermarket with a different service offering.
- E10. The supercentre concept is only in an embryonic testing stage in New Zealand but the business model – which differs from that of traditional supermarkets – has had widespread success internationally. It takes time for a supercentre operation to develop to meet the conditions applicable to a particular area. Wal-Mart is recognised as a leading operator of supercentres. In the United States, Wal-Mart started in a very small way, opening only nine supercentre stores over its first five years and then 295 stores in the following five years. One study showed that grocery prices in the US supercentres were 15%-25% lower than supermarkets in the same area.
- E11. The Warehouse has a number of stores suitable for conversion to the “Extra” format. It also owns additional land on which food and general merchandise stores could be constructed, is an established and well-recognised brand, and has an established distribution network. The Commission considers that it is uniquely placed as a potential competitor to the supermarkets, regardless of whether or not the “Extra” concept is fully deployed as planned. For other firms that may consider competing against supermarkets, access to suitable sites would be particularly problematic.
- E12. The acquisition by Foodstuffs or Woolworths would at this stage of development result in The Warehouse ceasing to be an existing supermarket retailer in a small number of regions, and a potential supermarket retailer in a number of other regions. The benefits of the innovative supercentre concept introduced by a third maverick player would be lost.
- E13. The acquisition would foreclose the potential for The Warehouse to be used by any other independent party as a springboard to entering the market.
- E14. The likely competition effects of either Foodstuffs or Woolworths owning The Warehouse are very similar.

The Relevant Markets

- E15. For its analysis the Commission first must define the relevant markets affected by the proposed acquisitions in order to assess the likely competition effects. The Warehouse is principally engaged in the retailing of general merchandise, and recently, the retailing of groceries in its Warehouse Extra stores. Supermarkets are principally engaged in the retailing of groceries.

- E16. The Commission has found that the main reason consumers shop in supermarkets is that they value the one-stop-shop concept. Convenience stores and specialist stores, for example, butchers, greengrocers and bakeries provide alternative sources of those products sold in supermarkets, but they do not provide a satisfactory alternative to supermarkets for most consumers seeking to purchase a wide range of grocery items at the one time, such as when weekly shops are undertaken.
- E17. The Commission has concluded that supermarkets operate within a discrete product market for retailing groceries. This is consistent with previous decisions, and with overseas competition cases. It is recognised, however, that supermarkets are differentiated. Each banner has a different price/service mix.
- E18. In order to frame the geographic boundaries of local markets, the Commission has assumed that to avoid price increases of around 5% consumers are likely to travel up to around 5 km to an alternative supermarket, and depending on the locality may travel further. Accordingly the principal focus of the Commission's analysis in this case is an approximately 5 km radius around each existing and planned Extra store. The Commission recognises that neighbouring supermarkets (and supercentres) inside this area are likely to be closer substitutes than those further away.
- E19. The applicants and The Warehouse purchase grocery items from wholesalers and other suppliers located throughout New Zealand giving rise to a national wholesale market for the supply of groceries.
- E20. The Warehouse's current primary focus is the retailing of general merchandise. The Commission has considered whether there is likely to be any competition concerns in the markets for general merchandise. Foodstuffs and Woolworths sell a small range of general merchandise through their supermarkets, constituting a small percentage of their sales revenue. However, as there are several other major general merchandise operators, the Commission does not consider that competition in general merchandising will be affected in a real way. Consequently, the Commission has decided not to analyse these markets in this case.
- E21. The Commission concludes that the relevant markets for the consideration of the applications are:
- the markets for the retailing of grocery items in supermarkets, incorporating local markets not less than 5 km in radius from a current or proposed Warehouse Extra in:
 - Mt Wellington, Whangarei and Te Rapa;
 - a number of locations that are confidential; and
 - other regions where there is a credible potential for a roll out of a supercentre.
 - the national market for the wholesale supply of groceries.

Factual and Counterfactual

- E22. When assessing the competitive impacts of an acquisition, the Commission assesses the likely situation with the acquisition (the factual) with the likely situation without the acquisition (the counterfactual).
- E23. Under the factuals for each acquisition The Warehouse would be under the ownership and control of Foodstuffs or Woolworths. Significantly, in relation to the supermarket markets, The Warehouse Extra would cease to be an actual or potential competitor, and only two supermarket groups would operate.
- E24. Under the counterfactual for each acquisition, The Warehouse would remain independent from both Foodstuffs and Woolworths. Included in these counterfactuals is the continued operation of the “Extra” supercentres, and their potential to be rolled out in other regions. Accordingly, there would be three independent supermarkets operating, or having the potential to operate, in the supermarket markets with The Warehouse providing a different and innovative type of offering.

Competition Analysis

- E25. Woolworths and Foodstuffs operate supermarkets throughout New Zealand. Over the country as a whole, Foodstuffs collectively accounts for 56% of supermarket sales and Woolworths 44%. In all regions, the markets are highly concentrated, and only in Mt Wellington and Whangarei do Foodstuffs and Woolworths face a third competing supermarket, The Warehouse Extra. The applicants will shortly face competition from The Warehouse in Te Rapa, Hamilton.
- E26. In Mt Wellington, Whangarei and Te Rapa, The Warehouse is an existing competitor, or planned competitor, and its acquisition by either applicant would see the disappearance of the only third competitor with no other likely entrant in the foreseeable future.
- E27. In Mt Wellington, there are six supermarket banners in operation: two owned by Foodstuffs, three by Woolworths and a Warehouse Extra. In the first eight months since it opened, the Warehouse Extra has accounted for a reasonable volume of total market sales. In the Whangarei market there are three Foodstuffs supermarkets, three Woolworths supermarkets and a Warehouse Extra. In the first four months since opening, The Warehouse Extra has accounted for a similar sales volume as that in its Mt Wellington store.
- E28. The Commission considers that the sales figures for The Warehouse Extra do not fully reflect the full extent of the competitive effect The Warehouse will have in these markets, which would be lost in the factual situations. The figures may well come to understate the impact, particularly as The Warehouse management refines the Extra concept and operations, and as they move out of the shadow created by the acquisition proposals.
- E29. In principle, the removal of an existing competitor or potential competitor may not raise a concern if further entry by another operator is likely within a reasonable time frame and with sufficient scale. However, new entry seems very unlikely in the case of supermarket markets.
- E30. The Commission considers that there are high barriers to new entry into the supermarket markets. The barriers include access to suitable sites, obtaining

resource consents and achieving sufficient scale in supermarket retailing. Major overseas operators have indicated to the Commission that they have no plans to enter the New Zealand markets; nor have potential domestic operators indicated any intention or likelihood of entering.

- E31. The presence of high barriers to entry is also borne out by there being no other new entry by a supermarket operator for over 20 years, even since the consolidation in the markets that took place in 2002.
- E32. Both Foodstuffs and Woolworths have indicated that suitable sites for their expansion are difficult to find. This supports the view that access to suitable sites would be a problem for a new entrant.
- E33. The Warehouse is a recent entrant in Mt Wellington and Whangarei, and a near entrant in Te Rapa, and is the only potential entrant into the supermarket markets elsewhere. This is because it is in the unique position of being able to overcome the high barriers to entry into supermarket retailing, by virtue of its innovative track record in general merchandising, its existing infrastructure, a number of existing sites with food consents, a landbank of sites able to be developed in the future, a distribution system, and an established brand. The Warehouse is also able to achieve economies of scope (from the joint supply of general merchandise and groceries) to offset its lack of scale in supermarket retailing, in comparison with the incumbent supermarkets, at least during the early years.
- E34. The supercentre concept is proven overseas, works more often than not, and is directly based on the combination of groceries with general merchandise under one roof. Other existing large retailers would be much less able to provide this combination from their existing operations and infrastructure.
- E35. Foodstuffs and Woolworths compete against one another on everyday grocery item prices, by advertising special prices and offering different product ranges and other incentives, such as fuel discount vouchers and loyalty schemes. However, they operated in a duopoly before Warehouse Extra entered some markets, and would do so again if either proposed acquisition were to proceed.
- E36. Duopolies protected by high entry barriers are not conducive to competitive outcomes. While some competition will occur between the two firms, such market conditions do not guarantee the consumer benefits that are to be expected when competition is fully effective.
- E37. Both applicants argued that The Warehouse Extra's supercentres do not pose a competitive threat, and that the concept will likely fail because The Warehouse does not share their buying power advantages, is therefore not price competitive, and is failing to attract shoppers. The Commission does not share this view. The Warehouse is a major corporate with a successful track record of expansion and innovation. The Warehouse will trial the "Extra" concept for some time. Overseas, the introduction of supercentres in various countries has seen a period of establishment and adaptation followed by major growth. The Commission considers it is not for the Commission to determine whether the "Extra" concept will succeed or fail. Rather it is for the market to determine whether this venture will ultimately be successful.
- E38. Foodstuffs and Woolworths have pointed out that the supercentre model has not been successfully adopted in Australia, the country which is most economically and culturally similar to New Zealand. However, the Commission notes Coles

Myer's announcement in November 2006 that it intends to open 80 supercentres in Australia. It described the format as the fastest growing format in the world.

- E39. The Warehouse is already price competitive. While its existing stores' prices are within the discount/full service price range, its prices are not currently the lowest, nor are they the highest. The Commission notes that it is not necessary to sell at the lowest price to be a very effective competitor. If The Warehouse provides a combination of offering, service and price that appeals to consumers, it would provide competitive constraint in the market. The Warehouse has a product in the Warehouse Extra that is clearly differentiated from its supermarket competitors by offering a full range of groceries and general merchandise under the one roof.
- E40. The Commission considers that The Warehouse brings an important competitive value to the markets as a "maverick" new entrant. That is, it has provided a non-typical supermarket with a different business model from that of Foodstuffs and Woolworths. It is also strongly motivated to succeed with its Warehouse Extra and thereby increase its general merchandise sales. It is likely to have an impact on competition out of proportion to its market size because it offers an innovative, new shopping service to consumers.

Competitive Effects

- E41. Acquisitions that result in such highly concentrated markets may lessen competition in two main ways:
- by removing competition constraints that lead to an increase in market power of the remaining firms acting independently (non-coordinated effects); and/or
 - by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).
- E42. The Commission considers that in the factual both the merged firm and the other remaining supermarket group would have less incentive to compete vigorously with each other due to the loss of the competitive constraint of The Warehouse (non-coordinated effects). The acquisition of The Warehouse would allow the acquirer to raise prices, knowing that customers lost to The Warehouse would be 'recaptured' within the combined entity. In addition, the loss of an innovative competitor would also remove dynamic competitive pressure on Woolworths and Foodstuffs over time to improve their offerings by further reducing prices, improving service and quality or being more innovative.
- E43. The Commission also considers that either of the proposed acquisitions would make coordination between Foodstuffs and Woolworths more likely, effective and stable in the factual than in the counterfactual (coordinated effects). Woolworths and Foodstuffs sell many similar grocery lines on which they could coordinate prices. The proposed acquisitions would restore a duopoly of two evenly-matched competitors that would make coordination easier. With the elimination of The Warehouse, there are unlikely to be any other factors that would destabilise coordination, such as another maverick firm, or a competitive fringe. The incumbent supermarkets would be able to detect any deviation from coordination because they constantly monitor each other's prices, and effective

retaliation need only be in the form of the risk of temporarily abandoning the coordinated practices and reducing prices/ margins to pre-coordination levels.

- E44. These adverse effects are likely to materialise not only in the areas where The Warehouse has already rolled out, or plans to roll out, its Extra stores, but also in those regions where there is a credible potential for The Warehouse to roll out the supercentre concept over time. In contrast, in the counterfactual, the presence of an independent innovative maverick like The Warehouse is likely to provide an effective competitive constraint on both Woolworths and Foodstuffs, and substantially reduce the likelihood of coordination.

The National Market for the Wholesale Supply of Groceries

- E45. Both Woolworths and Foodstuffs are major buyers in the market for the wholesale supply of groceries. The suppliers are the grocery manufacturers, of which there are many, both large and small, most tending to specialise in limited ranges of goods. Apart from the two supermarket operators, other buyers include independent dairies, petrol stations and other members of the route trade, although many of these are supplied by Foodstuffs wholesaling operations. The Warehouse has entered this market as a buyer, by virtue both of its selling of a limited range of dry goods through its conventional stores, and more recently by offering a wider range of groceries through its Extra stores.
- E46. Buyer power of the supermarket chains, insofar as it exists that is not countered by supplier power, could impact on market outcomes in various ways, and could in some circumstances adversely affect competition and harm consumers:
- Large buyers could extract lower wholesale prices from suppliers. If these buyers also have market power over consumers, they could maintain higher retail prices and pocket the difference to earn higher profits. However, lower wholesale prices could also be passed on to customers in lower retail prices, if retail competition were effective.
 - The pressure to lower wholesale prices could impact on suppliers in various ways. They might become more efficient; they might attempt to raise wholesale prices to other retailers lacking in buyer power; or they might be discouraged from making investments in process and product innovation, as well as in maintenance, if expected returns are reduced.
 - Consumers could be harmed by higher retail prices and a lower rate of innovation and product quality, or benefit from lower prices and improved efficiency and investment.
- E47. The presence of buyer market power is not always easy to determine, and its impact on competition in the wholesale groceries market could vary, depending upon the circumstances of each supplier of the thousands SKUs carried by supermarkets.
- E48. Without examining the position of each and every one of the many suppliers to supermarkets, it seems unlikely that the loss of The Warehouse as an independent grocery buyer would have a noticeable effect on the buyer power of the incumbents. The Commission recognises that, in the future, the Warehouse's share of purchases in the wholesale market could grow as it rolls out more supercentres. However, because the market for the wholesale supply of groceries is national, The Warehouse's share of purchases is likely to be far

lower than its share of retailing in local supermarket markets. In any case, in the future, it is far from certain that any increased ability for purchasers to negotiate lower prices from suppliers would be harmful to competition, especially if these lower prices are passed on to consumers.

Conclusions

- E49. In respect of the local supermarket markets, the Commission has concluded that the loss of existing and potential competition from an innovative firm in circumstances where it is the only likely entrant for the foreseeable future, and the other resulting foreclosure effects, will lead to a substantial increase in market power of the remaining incumbent supermarkets. As a result of the loss of this significant competitive constraint in the factual, there is a real risk that prices will be materially higher, and quality, service and innovation materially lower, than in the counterfactual through either or both non-coordinated or coordinated effects. Having reached these conclusions, the Commission cannot be satisfied that the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant supermarket retail markets.
- E50. The Commission is satisfied that, should the proposed acquisitions proceed, they will not have, or would not be likely to have, the effect of substantially lessening competition in the national market for the wholesale supply of groceries.
- E51. The Commission has declined to give a clearance to either Foodstuffs or Woolworths to separately acquire up to 100% of the ordinary shares of The Warehouse.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 21 December 2006. The notice sought clearance for the acquisition by Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-operative Society Limited and Foodstuffs South Island Limited (Foodstuffs (Auckland), Foodstuffs (Wellington), and Foodstuffs (South Island) respectively, (collectively Foodstuffs), or a company wholly-owned by those parties to acquire up to 100% of the ordinary shares in The Warehouse Group Limited (The Warehouse).
2. In addition, a notice pursuant to s 66(1) of the Act was registered on 17 January 2007. The notice sought clearance for the acquisition by Woolworths Limited (Woolworths) to acquire up to 100% of the shares in, or assets of, The Warehouse and/or of any interconnected body corporate of The Warehouse.
3. The issues raised from both applications are very similar. The information received from the applicants was compared against each other and was directly relevant to both applications. For these reasons, a combined investigation was undertaken and has resulted in the preparation of a single document outlining the Commission's reasons for its decisions on the applications.

PROCEDURE

4. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Extensions of time were agreed between the Commission and the applicants. Accordingly, a decision on both of the applications was required by 8 June 2007.
5. The applicants sought confidentiality for specific aspects of the applications. A confidentiality order was made in respect of the information for up to 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.
6. The Commission's approach to analysing the proposed acquisitions is based on principles set out in the Commission's *Mergers and Acquisitions Guidelines*.²

STATUTORY FRAMEWORK

7. Under s 66 of the Act, the Commission is required to consider whether the proposal is, or is likely to have the effect of substantially lessening competition in the market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition then it is required to grant clearance to the application. Conversely if the Commission is not so satisfied it must decline. In *Brambles v Commerce Commission*, the Court observed:

the position is that the Commission is obliged to decline to give clearance for a proposed acquisition if:

- a) The Commission is satisfied that the acquisition will have, or would be likely to have, the effect of substantially lessening competition in a market;
- b) The Commission is in doubt as to whether the acquisition will have, or would be likely to have, the effect of substantially lessening competition in a market.³

² Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004.

8. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.⁴
9. The substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission (No. 6)*, where the Court held⁵:

We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgement is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.
10. Further, in *Commerce Commission v New Zealand Bus Limited*, the Court confirmed:⁶

The Act defines “substantial” to mean real or of substance, and a “likely” effect is one that involves a real and substantial risk that the stated consequence will happen: *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554 at p562. Substantial lessening of competition is a relative rather than an absolute standard; it examines the state of competition with and without the transaction to determine whether, and the extent, market power will move along the spectrum from perfect competition to monopoly.”
11. In determining whether there is a change along the spectrum that is significant the Commission must identify a real lessening of competition that is not minimal.⁷ Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.
12. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and ordinarily able to be sustained for a period of at least two years or such other time frame as may be appropriate in any given case.
13. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced services, quality or innovation, for there to be a substantial lessening, or likely substantial lessening of competition, these also have to be both material and ordinarily sustainable for at least two years or such other time frame as may be appropriate.

ANALYTICAL FRAMEWORK

14. The Commission applies a consistent analytical framework to all of its clearance decisions. The first step the Commission takes is to determine the relevant

³ *Brambles New Zealand Limited v Commerce Commission* (2003) 10 TCLR 868 at 878

⁴ *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713 at 722.

⁵ *Air New Zealand & Qantas Airways Ltd v Commerce Commission (No. 6)* (2004) 11 TCLR 347 at 366.

⁶ *Commerce Commission v New Zealand Bus Limited* (2006) 11 TCLR 679 at 705.

⁷ *Fisher & Paykel Limited v Commerce Commission* [1996] 2 NZLR 731 at 758 and also *Port Nelson Limited v Commerce Commission* [1996] 3 NZLR 554.

market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:

- with the acquisition in question (the factual); and
 - in the absence of the acquisition (the counterfactual).
15. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual, in terms of:
- existing competition;
 - potential competition; and
 - other competition factors, such as the countervailing market power of buyers or suppliers.

THE PARTIES

Foodstuffs

16. Foodstuffs consists of three separate, regionally based co-operatives. Foodstuffs operates a range of retail outlets including supermarkets, convenience stores and liquor stores. Currently, the combined turnover for all three co-operatives is approximately NZ\$6.8 billion per annum. All three co-operatives have combined to submit the clearance application.
17. The three regional Foodstuffs' co-operatives are:
- Foodstuffs (Auckland) which covers the top half of the North Island;
 - Foodstuffs (Wellington), which covers the southern half of the North Island; and
 - Foodstuffs (South Island), which covers the entire South Island.
18. Each Foodstuffs store operates in a similar way to a franchise such as McDonalds. The franchise agreement covers store format, product range, pricing, marketing and store fit-out. There is a formal lease document covering the premises, and each store pays various levies to Foodstuffs for group advertising, training, and other support services.
19. Foodstuffs operates the supermarket banners Pak'n Save, New World and Four Square. Pak'n Save is a discount supermarket banner that has a relatively limited range of products and level of service. It is generally acknowledged as having the lowest average prices of any banner. New World offers a greater range of products and a higher level of service. Four Square stores are more akin to convenience stores than supermarkets, and are typically located in small catchment areas.
20. The three Foodstuffs co-operatives are not legally interconnected or associated. There is a level of cooperation between the three firms, which extends to joint venture purchases for overseas products and house brands. It appears that the three co-operatives compete at the wholesale level when purchasing from

suppliers. At the retail level, the three co-operatives do not compete as they each operate in quite separate regions. Each Foodstuffs co-operative holds the rights to the supermarket banner names in their respective areas. This precludes (for example) Foodstuffs (Wellington) opening a Pak'n Save in Auckland.

21. Foodstuffs co-operative members are owner/operators of each store. The head office of each Foodstuffs co-operative sets the recommended prices for its members as well as organises regional specials. Each store is obliged to comply with prices for regional specials, while for other products they can either implement the recommended price or apply a lower price. Owner/operators also have the flexibility to organise their own specials and introduce their own lines of products at their discretion. This flexibility has given rise to situations where two supermarkets that are both within the same Foodstuffs co-operative appear to compete with each other.
22. Each Foodstuffs co-operative also operates a cash-and-carry operation. In Auckland this is James Gilmour & Co Limited, in Wellington, Toops Wholesale Limited, and in the South Island, Trents Wholesale Limited.

Woolworths

23. Woolworths is a publicly listed Australian-based company with approximately 3,000 retail stores throughout Australasia. Woolworths operates a range of retail outlets, including supermarkets, general merchandise, liquor, petrol and consumer electronics stores. Currently, Woolworths has total retail sales of approximately A\$38 billion per annum from its combined Australian and New Zealand operations.⁸
24. In December 2005, Woolworths acquired Progressive Enterprises Limited (Progressive), which directly operates 150 supermarket stores in New Zealand, as well as coordinating an additional 48 franchise supermarket stores through its wholesale division.
25. Progressive operates the supermarket banners Woolworths, Foodtown and Countdown. In addition, it coordinates the SuperValue and Fresh Choice (predominately in the South Island) franchises. Woolworths, Foodtown and Fresh Choice stores are full service supermarkets offering a greater range of groceries than the Countdown banner. Countdown is Woolworths' discount banner that still offers full service, but in a large barn-like format with lower prices than the Woolworths' and Foodtown stores.

The Warehouse

26. The Warehouse is a publicly listed company that operates 85 general merchandise stores and 43 stationery stores in New Zealand. Currently, The Warehouse has retail sales of approximately NZ\$1.7 billion per annum.⁹
27. The Warehouse has grown from a single store, 25 years ago, into New Zealand's largest chain of general merchandise stores. It is widely considered to be one of the retail success stories of New Zealand.

⁸ Woolworths' website at <http://www.woolworthslimited.com.au/aboutus/ourcompany/index.asp>

⁹ The Warehouse Annual Report 2006.

28. In 2005,
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29. The Warehouse has been developing a new format in which some of its stores will be converted to sell a full range of groceries and fresh food in addition to the existing general merchandise offerings. The Warehouse has called this supercentre format “Extra”. The Warehouse has
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30. Extra supermarkets form a substantial part of an Extra store. They offer a full range of groceries ([] stock keeping units (SKUs) compared to [] carried by a Pak’n Save) including dry goods, fresh fruit and vegetables, delicatessen items, frozen goods, meat, and also an instore franchised bakery. Checkouts are shared with the general merchandise operation and groceries are packed for customers. Liquor is offered separately in an adjacent area with a separate checkout.
31. The Warehouse has now introduced its Extra concept at Sylvia Park (a new retail complex in Mt Wellington, Auckland) and in Whangarei. The Warehouse has also announced that it will convert its existing store at Te Rapa (in Hamilton). The Extra store at Sylvia Park has been open only since June 2006, and the Whangarei store since November 2006. The Te Rapa conversion is intended to be completed by Christmas 2007.

PREVIOUS COMMISSION DECISIONS

32. The Commission has undertaken several investigations into acquisitions concerning the supermarket industry.

Decision 438

33. On 25 May 2001, the Commission registered a notice pursuant to s 66(1) of the Act from Progressive, in which clearance was sought for it to acquire all of the shares in Woolworths New Zealand Limited (Woolworths NZ). At that time, Progressive was owned by Foodland Associated Limited, an Australian company. In New Zealand, Foodland Associated Limited operated the supermarket banners Foodtown, Countdown and 3 Guys. In addition, its wholesale distribution operation supplied the FreshChoice and SuperValue chains. Woolworths NZ was then owned by Dairy Farm International Holdings Limited. Woolworths NZ operated the Woolworths, Big Fresh and Price Chopper banners.
34. On the day the notice was registered, the relevant test for the consideration of the application was the dominance test. However, on the following day, 26 May 2001, the Act was amended such that the relevant test became one of a substantial lessening of competition.
35. In its consideration of Progressive’s application for clearance, the Commission considered the relevant markets to be:
- the market for the retailing of grocery items in supermarkets, incorporating regional markets not less than five km in radius; and

- the national market for the wholesale supply of groceries.
36. At the time of Decision 438, Progressive stores accounted for around 24% of supermarket shopping, while Woolworths NZ stores accounted for around 18%. The acquisition would have resulted in the combined entity accounting for around 42% of all supermarket shopping nationally. The three Foodstuffs co-operatives collectively accounted for the balance of about 58% nationally.
 37. The Commission accepted divestiture undertakings from Progressive in respect of the 3 Guys store in Te Awamutu and the Foodtown store in Birkenhead on Auckland's North Shore. On 13 July 2001, the Commission granted clearance for the acquisition on the basis that the proposal would not result, or would not be likely to result, in any person acquiring or strengthening a dominant position in any market.¹⁰
 38. Foodstuffs (Auckland) appealed to the High Court, and then the Court of Appeal, on the basis that the Commission's application of the dominance test in Decision 438 was inappropriate, given that the Act was amended the day after receipt of Progressive's application changing the test from dominance to a substantial lessening of competition.
 39. The Court of Appeal held that the Commission should have applied the substantial lessening of competition test. The Commerce (Clearance Validation) Amendment Act 2001 validated all decisions made under the dominance test prior to the transitional amendment, except for Decision 438 in relation to Progressive's previous application.

Decision 448

40. On 24 October 2001, the Commission registered another notice pursuant to s 66(1) of the Act from Progressive in which it sought clearance to acquire all the shares of Woolworths NZ. This time, the Commission considered the proposed acquisition under the substantial lessening of competition test. Again, Progressive offered to divest the Te Awamutu and Birkenhead stores.
41. On 14 December 2001, the Commission declined to grant clearance for the proposal for the following reasons:¹¹
 - The factors that facilitate coordination appeared to be present. The market was highly concentrated, with the two firm concentration ratio for all the affected markets being 100%. The reduction from three to two competitors was considered likely to materially increase the potential for coordinated market power, and to substantially lessen competition. The Commission considered that the divestment undertaking would not alleviate these concerns.
 - The Commission considered that there were high barriers to entry, and that the threat of new entry was unlikely to provide sufficient constraint post-acquisition.

¹⁰ Commerce Commission, *Decision No. 438: Progressive Enterprises Limited / Woolworths NZ Limited*, 13 July 2001.

¹¹ Commerce Commission, *Decision No. 448: Progressive Enterprises Limited / Woolworths NZ Limited*, 14 December 2001.

- The Commission was unable to identify any other competition factors that would prevent a substantial lessening of competition (such as constraint from buyers or sellers, or efficiency arguments).
 - Accordingly, the Commission could not be satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the market for the retailing of grocery items in supermarkets.
42. Subsequent to the Commission releasing Decision 448, Progressive appealed the decision of the New Zealand Court of Appeal (that the substantial lessening of competition test should apply) to the Privy Council. The Privy Council upheld the appeal (ruling that the dominance test should apply) and as a result, Progressive acquired Woolworths NZ in June 2002.

Woolworths Acquisition of Progressive in 2005

43. In December 2005, Woolworths acquired Progressive. The Commission received a complaint about the acquisition from an anonymous group of suppliers and, as part of its surveillance programme, conducted an investigation to ascertain whether the acquisition might be in breach of s 47 of the Act. Section 47 (1) of the Act provides that:

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

44. In essence, the complainants alleged that Woolworths ownership of Progressive would give Woolworths significant market shares in the retailing and wholesale purchase of groceries in both Australia and in New Zealand, and that Woolworths would then be in a position to exert market power (monopsony power) in its negotiations and buying relations with suppliers of groceries. The complainants asserted that the relative size and strength of Woolworths would be such that small local suppliers would be forced out of business because such suppliers could not compete on price with larger Australian suppliers.
45. The Commission's investigation was somewhat hampered by the unwavering claim of anonymity by the complainants, which impeded the Commission's ability to fully test the assertions of the complainants. However, ultimately, the Commission concluded that the difference between the factual scenario (ownership of Progressive by Woolworths) and the counterfactual, (continued ownership by Progressive) was likely to be minimal such that the acquisition was unlikely to have resulted in a substantial lessening of competition.

WOOLWORTHS' AND FOODSTUFFS' SHAREHOLDINGS IN THE WAREHOUSE

Acquisition by Foodstuffs of a 10% Shareholding in The Warehouse

46. On 7 June 2006, Foodstuffs announced to the New Zealand Stock Exchange that it intended to purchase (through nominee companies), in aggregate, up to 10% of the ordinary shares on issue by The Warehouse.
47. On 5 July 2006, Foodstuffs announced to the market that it had purchased, in aggregate, 10% of the shares in The Warehouse. Since then, as a result of employee share option schemes, a number of new shares have been issued by The Warehouse. In March 2007, in order to maintain its 10% shareholding,

Foodstuffs acquired further shares in The Warehouse. Foodstuffs' shareholding in The Warehouse remains around 10% and does not entitle it to representation on the Board of The Warehouse.

48. There has been some speculation that Foodstuffs timed its share purchase to commence on the day that The Warehouse opened its Sylvia Park Extra store. However, [], the date was a coincidence.

49. Tony Carter, Managing Director, Foodstuffs (Auckland), advised the Commission that Foodstuffs' rationale for the acquisition of its shareholding in The Warehouse was thus:

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Acquisition by Woolworths of a 10% Shareholding in The Warehouse

50. Between 18 and 27 September 2006, Woolworths also acquired a 10% shareholding in The Warehouse. This acquisition occurred less than two weeks after Stephen Tindall announced plans to privatise The Warehouse in an arrangement with Pacific Equity Partners.
51. Tom Pocket, CFO, Woolworths, explained Woolworths' rationale for acquiring 10% of The Warehouse thus:

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52. The Commission was aware of these acquisitions and made preliminary inquiries, but it did not undertake a full investigation of them as no control was

attached to the shareholdings in the form of the ability to appoint directors to the Board of The Warehouse, and the shareholdings did not prevent the acquisition by another party.

DECISIONS 438 AND 448 VS THE PRESENT PROPOSALS

53. In Decisions 438 and 448, the Commission considered the competition effects of the amalgamation of the number two and three players in the supermarkets market. At the time of those Decisions, Progressive and Woolworths NZ were considerably smaller in size than the only other competitor, Foodstuffs. In its consideration of the present proposals, the Commission must assess the competition effects of either of the more evenly matched Woolworths and Foodstuffs acquiring the new entrant to the market, The Warehouse, and in particular, whether either acquisition would be likely to substantially lessen competition.

INDUSTRY BACKGROUND

Supermarkets

54. Supermarkets carry a wide-range of fast-moving consumer goods, principally groceries but increasingly a range of other products. Typically a supermarket is characterised by offerings of meat, delicatessen goods, seafood, bakery products, fresh fruit, vegetables and flowers, beer and wine, frozen goods, dry groceries, dairy products, health and beauty products and general merchandise. General merchandise encompasses the non-food items in a grocery store, including housewares, toys, greeting cards, and hardware. To date, general merchandise comprises a small part of the supermarket offering.
55. Supermarkets have evolved from a format that originated in the United States in the early 20th century. The Grocers' Review cites Coriolis Research as stating that the modern supermarket came about as a result of three inventions – self-service, the big box retailer and the shopping cart.¹²
56. As discussed in the market definition section below, goods in supermarkets are not necessarily priced below those in specialist stores. Nor can they always match the convenience of dairies, Star Marts and service stations. Their attraction is that they offer a wide range of goods at moderate prices and they allow consumers to undertake their main shop for groceries under the one roof, without the cost and inconvenience associated with multiple transactions.
57. An important feature of the New Zealand market is the degree of ownership concentration. For the past five years all main supermarkets throughout New Zealand have been owned either by Woolworths or by one of the three Foodstuffs co-operatives. Consumers have the choice of a Woolworths-owned supermarket or a Foodstuffs-owned supermarket.
58. While increasing market aggregation appears to be a common theme in papers seen on supermarket shopping overseas,¹³ it would seem few countries have the degree of market concentration found in New Zealand.

¹² "Forward into the Past? Will the New Zealand Grocery Retail Industry Come Full Circle?" *Grocers' Review*, July 2004.

¹³ See, for example, Howard Smith, "Supermarket Choice and Supermarket Equilibrium", *Review of Economic Studies* (2004) 71, 235-263.

59. On an aggregated basis, Foodstuffs accounts for an estimated 56% of the total New Zealand's supermarket grocery sales, with Woolworths accounting for 44% of total grocery sales.¹⁴ At this time, the sales from the two existing Warehouse Extra stores are negligible in a national context.
60. There is a degree of uniformity in the products sold by all the supermarkets, particularly in respect of the top selling lines. However, prices and services differ depending on the positioning of the supermarket banner. Both Foodstuffs and Woolworths offer different banners that can be placed along a spectrum encompassing factors such as price, quality, range and service. Foodstuffs' Pak'n Save and Woolworths' Countdown stores tend towards the discounted price end of the spectrum, while Foodstuffs' New World and Woolworths' Foodtown and Woolworths banner are situated towards the other range, quality and service end of the spectrum.
61. The Warehouse operates a discount model that is akin to the Pak'n Save and Countdown supermarkets. Typically, discount stores offer lower prices but have a reduced range of products and limited levels of service. A full service supermarket offers an increased range of products (and a high quality range) with higher levels of service but at, typically, higher prices. Foodstuffs' Pak n Save discount banner is the market leader in terms of lowest prices.
62. This is demonstrated by the price indices in the following confidential table provided by Woolworths in its application.

Confidential Table 1: Price Indices of Supermarket Banners

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]Source: Woolworths' Application

¹⁴ Estimates of aggregated market share provided by both Foodstuffs and Woolworths.

63. Table 2 shows the number and type of stores of each of the present competitors as at March 2007.

Table 2: Number of Supermarket Stores Operated by each Party

Company	Banner Group	Banner type	Number of Supermarkets
Foodstuffs	Pak n Save	Discount	48
	New World	Full Service	129
	<i>Total</i>	-	<i>177</i>
Woolworths	Countdown	Discount	57
	Woolworths/Foodtown	Full Service	93
	Franchise stores	Discount	48
	<i>Total</i>	-	<i>198</i>
The Warehouse	Extra stores	Discount	2 (with the Te Rapa store to open in late 2007)
Total		-	377

Source: Foodstuffs' and Woolworths' respective applications for clearance.

The Warehouse Extra Project

64. The principal aim of The Warehouse in investing in the supercentre concept has been to increase sales of general merchandise and apparel rather than necessarily achieve profitability on food in its own right.¹⁵ The initial intentions were both to add groceries to some existing stores, which required that some space used for general merchandise and apparel be converted to groceries, and to build new greenfield stores capable of carrying both general merchandise and groceries.
65. The Warehouse is seeking to achieve additional general merchandise sales by increasing the number of customers passing through its stores. It hopes to attract new customers either by the merit of its grocery offering in itself (which in range matches that of supermarkets) or by the advantages of being able to buy both general merchandise and groceries under the one roof.
66. A paper prepared within The Warehouse entitled "Food Strategy", dated September 2005, asks the question: "Why consider food?" The six points to the answer were:

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¹⁵Ian Morrice, CEO, The Warehouse, at an interview with Commission staff on 15 February 2007. The Warehouse refers to this as the "halo effect".

67. The Warehouse envisages that while margins achieved on groceries may be less than those being achieved by supermarkets, this will be offset by increased sales on higher-margin general merchandise. This is the underlying rationale of Wal-Mart's supercentres in the US and elsewhere, and is the basis of The Warehouse's view that groceries do not necessarily need to be profitable in their own right.

68. Stephen Tindall advised the Commission that¹⁶:

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69. The Warehouse's plans for the timing and number of its Extra roll outs have varied over time. Its Board papers of April 2005 indicated that it has

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¹⁶ Interview with Commerce Commission staff, 16 February 2007.

Confidential Table 3: Possible Store Conversions

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Confidential Table 4: Possible Greenfield Store Developments

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70. The Warehouse always envisaged that the concept should be trialled in a limited number of stores before it proceeded with a more general roll out. Stephen Tindall advised the Commission that:

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71. Although the Sylvia Park store was the first Extra concept store, that was more to do with the timing of the opening of the new shopping mall than a view that it was a suitable site for testing the concept.

[

]. The Sylvia Park shopping mall is incomplete at this stage and accordingly, the foot traffic has not yet reached anticipated volumes – a point expressed by Foodstuffs, Woolworths and The Warehouse. The Warehouse informed the Commission that it considers its first test store to be its Whangarei store. This store opened on 30 November 2006.

72. The Warehouse noted that the
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73. Currently, The Warehouse has two distribution centres, one in Auckland and one in Christchurch, which it uses to supply all its existing stores. The Auckland distribution centre supplies the upper North Island stores, and the Christchurch distribution centre supplies the entire South Island as well as the Wellington region.
74. The Warehouse has modified its existing Auckland distribution centre to handle an additional range of products for the Extra stores at Sylvia Park and Whangarei.
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75. The Warehouse also advised the Commission that
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The Warehouse Extra – the Results to Date

76. As noted above the first Extra opened on 8 June 2006 at the Sylvia Park shopping mall in Auckland. The complex itself has not yet been completed and therefore, the forecast volume of foot traffic has not yet materialised. This has been confirmed by a number of parties interviewed by the Commission during its investigation of the applications. Consequently, the figures to date do not provide a reliable guide to how it might perform in the longer term. [], the Commission notes that since opening, The Extra store at Sylvia Park has managed to capture around [] of the market share in the market that includes the Sylvia Park supermarkets. This is [].¹⁷
77. The other Warehouse Extra opened so far is in Whangarei, which opened on 30 November 2006. The Warehouse regards this store as its test store and it is using it to determine how the supercentre concept needs to be promoted and adapted for New Zealand conditions. The Warehouse recognises that testing will take some time, it suggested [] to the Commission, before it will be able to tell whether the concept is likely to be viable in the long run.
78. The Warehouse has advised the Commission that the results of its Extra stores so far have been
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79. In addition, The Warehouse informed the Commission that
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¹⁷ More complete data is displayed in the Competition Analysis section below.

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80. [

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81. Ian Morrice, CEO of The Warehouse advised the Commission:

Well in any given site we think it will probably be, we now think anyway particularly having tested a couple of different sites,

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] Why we are doing this though because at the end of the day we are not doing it to copy anybody else. We are doing it because we believe that we can sell more general merchandise and apparel. I mean that fundamentally that's why are doing it and that's why in our format we concentrate on the things that we are already good at so we are already pretty successful at selling health and beauty for example so we have invested a lot more space and effort on that pharmaceutical and beauty area than other retailers would because we are fundamentally doing this to sell more of what we already sell which we are very efficient at distributing and we are quite profitable in doing and the dynamic I am talking about in terms of

[

] to change – it's what we call the halo effect. So in other words the effect of having everything under one roof means that you get more visits by the same people than you would have done before by having it all there and sure sometimes they buy food but actually the reality is that even if they get into the habit buying the food regularly with us with they will pick up the general merchandise pretty much in every visit and

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The Experience of Supercentres Overseas

82. The supercentre format¹⁸ was first introduced in Europe by the French retailer, Carrefour, in 1963. Other firms followed it into the market including Auchan, Leclerc, Tesco and ASDA Wal-Mart. US supercentres include Wal-Mart, Super K-mart, Super Target, Meijer and Fred Meyer.
83. Foodstuffs has provided the Commission with a paper by CRA entitled “Hypermarkets”, which provides background on the supercentre format in the United States. This paper stated in part:

The hypermarket ... format combined full-scale supermarket offerings and a wide range of general merchandise items. There were only four hypermarkets opened in the USA, each of a size of 220,000 square feet. Each store required an extremely high sales volume to break even, relying on a large distribution of customers who were willing to travel long distances for the

¹⁸ For the purpose of general discussion, the term supercentre is used to cover hypermarkets and supercentres. While there are some differences between them (hypermarkets are generally found in Europe and tend to be larger than supercentres, which is the name Wal-Mart has given to its stores in the United States), they are considered to be sufficiently similar to place within the one generic term for much of the discussion in these reasons for the Commission's Decisions.

convenience of having food and a large range of cheap merchandise under the same roof. The concept did not perform well; essentially they were too large to be successful.

After hypermarkets failed, Wal-Mart opened the first “supercenter” in 1988. Supercenters combine food retailing with general merchandising and pharmacy under one roof, devoting 40% of floor space to food retail. An important difference is that supercenters, in contrast with hypermarkets, represent a general merchandiser expanding into the grocery market. Wal-Mart has been expanding via the supercenter format ever since and has attempted to establish itself internationally. K-Mart and Target followed Wal-Mart by establishing Super K-Mart in 1991 and 1995 respectively.

84. Wal-Mart is the largest retailer in the United States, and a Deutsche Bank study suggested that in 2002 it operated 1,258 of the 1,766 supercentres in the US.¹⁹ The study said that it believed that the format is highly profitable. Wal-Mart currently operates more than 2,200 US supercentres.²⁰
85. Wal-Mart’s early days with the concept are discussed in a series of research reports produced by Coriolis Research, a New Zealand company that undertakes market research in the food and fast moving consumer goods sectors. It notes²¹:
- In 1986 Wal-Mart was a regional discounter with sales of US\$11.9b through 940 discount department stores and 49 warehouse club stores across 23 states. In its FY1986 annual report, Sam Walton announced:
- New retail concepts, presentations and formats will be tested. The first of two Wal-Mart SuperCenters, a combination food and general merchandise retailing center in excess of 220,000 square feet, is planned to open in late 1987. These Super Centers, a joint venture of the company and Cullum Companies, are a result of our continuing interest in the experimentation with and understanding of what we believe to be significant new retailing vehicles. The Super Centers will be a modification of the European "hypermarket" concept.
- Wal-Mart opened a range of different store formats, with very different strategies, including different ranges, pricing, merchandising and decor before it settled on a successful format. It initially opened stores under the Hypermarket*USA banner, then additional stores under the name Wal-Mart Supercenter.
86. The Coriolis report also discussed the rate of growth²².
- Wal-Mart opened its first combion general merchandise and grocery store in December 1987. It opened a total of 9 stores over the first five years of operation while the concept was being perfected.

¹⁹ Deutsche Bank, *US Supermarkets Between a Rock and a Hard Place*, 11 February 2003.

²⁰ Emek Basker. *The Causes and Consequences of Wal-Mart’s Growth*, April 2007.

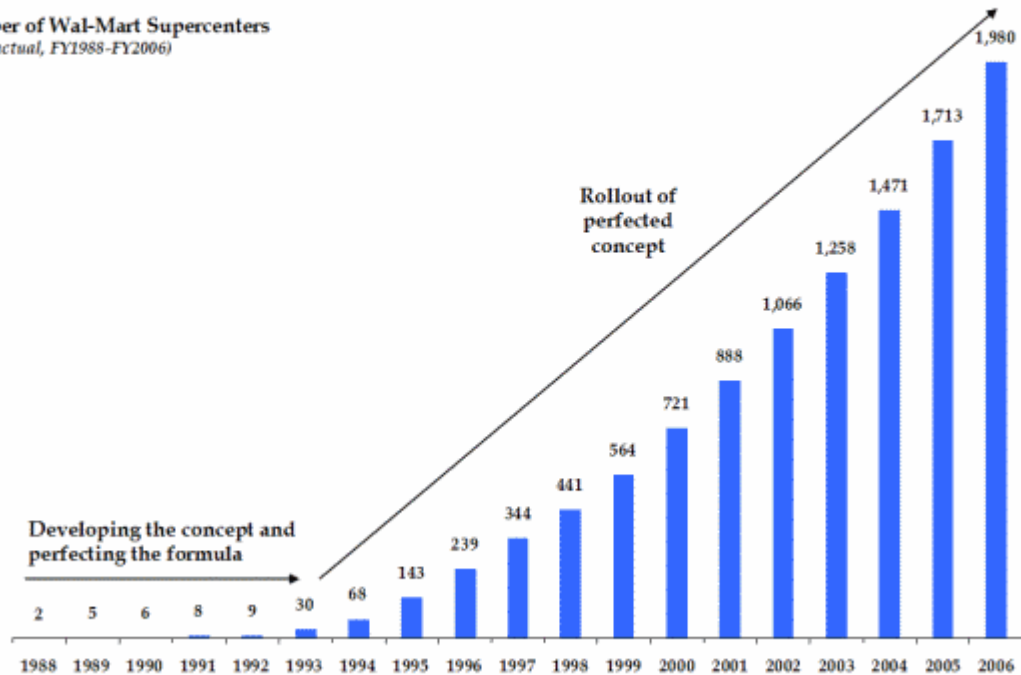
²¹ Coriolis, *Chart Watch Q2 2006, Part 1*, 2006.

²² *Ibid.*

MASSIVE GROWTH ONCE YOU GET IT RIGHT

Wal-Mart spent a period of time developing the concept before making a massive roll-out

Number of Wal-Mart Supercenters
(units, actual, FY1988-FY2006)



CORIELIS
RESEARCH Source: various annual reports; Corielis analysis

Chart Watch

In 1992, once they had the concept right, Wal-Mart went on a massive expansion that continues to this day.

The ROI (Return on Investment) has been not only better than regular Wal-Mart's or Sam's, but beyond our expectations." David Glass, CEO, Wal-Mart, May 1993

To date (June 2006) they have opened over 2,000 Wal-Mart Supercenter stores across the country. In addition, Wal-Mart has exported the Supercenter format to other countries, with (somewhat mixed) success.

87. A less favourable view of Wal-Mart's growth is provided in a memorandum provided to the Commission by Woolworths, prepared by Dimasi.²³ This stated:

Wal-Mart's recent history with their supercenters in the US shows that their price leadership in groceries is not translating into a strong growth strategy. The chart [] shows the growth of Wal-Mart sales in total as well as same-store sales for all of its US stores (not just supercenters, though they are the majority of the outlets the company has in the States). The first thing that becomes apparent when looking at Wal-Mart though is that growth is coming primarily from the opening of new stores rather than generating significant increases in same-store sales. Even with these data constraints, the graph clearly shows that growth in US same store sales has been decelerating since 1999, despite the fact that supercentres have gone from being 19% of stores in 1999 to 51% of US stores in 2006.

88. The Dimasi memorandum also noted:

While other hypermarkets do not necessarily have the imperative of following Wal-Mart's lead in being the low-price leader, the hypermarket formula in general also imposes significant logistical and distributional costs on an organisation. Wal-Mart's key point of customer service is low prices. No matter what the format, the retailer aims for a market leading position on prices. Other retailers (Costco, Carrefour, Tesco etc) do not go to market with

²³ Dimasi Memorandum, *Hypermarkets*, 17 April 2007.

such an emphasis on lowest prices. They are not aiming necessarily at a higher price point strategy or even ceding the low end of the market to Wal-Mart, but the main point of difference with their hypermarkets is breadth of offer. Companies and organisations in general are usually only truly good at providing one core business proposition. Wal-Mart's hypermarkets (or supercenters as they call them) are fairly unique in that they compete on two propositions: breadth and price.

89. The Coriolis report²⁴ contains a table, reproduced as Table 5, that indicates where it considered the supercentre concept had succeeded or failed.

Table 5: The Success and Failure of Hypermarkets in Other Countries

Country	Successful	Failed
United States	Wal-Mart Supercenter Super K-mart Super Target Meijer Fred Meyer (Kroger)	Auchan Carrefour various others
Canada	Loblaw's Real Canadian Superstore Wal-Mart Supercenter	
United Kingdom	TescoExtra ASDA Wal-Mart	
Australia		Super K-mart Pick'n Pay Hypermarket
France Belgium Spain Italy other Europe	Carrefour Auchan Leclerc various others	various smaller ventures
Chile	D&S Jumbo	Carrefour
Argentina	Carrefour Pao de Acucar Wal-Mart	Ahold
East/SE Asia	Carrefour Wal-Mart Tesco Dairy Farm	Ahold

Success of Supercentres

90. Since the concept was first introduced by Carrefour in 1963, supercentres have become an important part of the retailing scene in most of the advanced overseas economies. The Coriolis table above suggests that new entry has generally, but not inevitably, been successful. Also, the literature emphasises

²⁴ Coriolis, *Chart Watch Q2 2006 Part 1*, 2006.

differences in the formats are important, as what works in one country does not necessarily work in another country.

91. Also, the success of one operator does not necessarily mean that other operators will be equally successful. As stated by Coriolis:²⁵

While a number of groups tried to develop a successful hypermarket concept for the United States market, there were more losers than winners. The winners were clearly those groups with a strong existing business with strong operational disciplines (Wal-Mart and Target).

92. The experience of Wal-Mart in entering the German market has been cited as an indication that success has not always been straight-forward. Some commentators have suggested that Wal-Mart's lack of success in this market was due to its failure to adapt the concept to local culture, rather than a failure of the concept per se.

93. The table also indicates that Australia does not have supercentres. Coriolis, when discussing the possible success of the Warehouse Extra, stated:²⁶

The one major failure of the hypermarket concept to date has been the Australian market, where both Coles Myer's Super K-mart and Pick'n Pay from South Africa failed, which could be a concern as the Australian market is the closest structurally, economically and culturally to New Zealand.

94. Woolworths has also pointed out the lack of success of the concept in Australia. Dimasi in its memorandum to Woolworths stated:

At the time of the Super K-mart experiment, the Australian retail landscape was populated by numerous stand-alone supermarkets, a growing shopping centre industry and lively High Streets. Given that there is no existing unmet set of consumer demands, Super K-mart needed to provide consumers with compelling reasons to shop there. The fact that the stores were 'hypermarkets' was, by itself, of no consequence to Australian consumers, and the concept floundered for a few years before being abandoned.

95. In its interpretation of events at the time, Coriolis stated:²⁷

(I)n both cases, we believe the reasons for failure do not apply to The Warehouse Extra. In Cole's case, from talking to people involved at the time, we believe the problem was internal politics between the Coles Supermarket management and the K-mart management and the inability of IT systems to talk to each other across the group. In Pick'n Pay's case, the chain was boycotted by Australian unions due to (at the time) apartheid in South Africa and as a result was unable to roll out the concept beyond one store. However, the one store they opened is still in operation in Queensland, though it is now owned by Coles.

96. However, despite its previous problems with the Super K-Mart concept, recently Coles Myer Limited announced its intention to develop some of its co-located K-mart stores and Coles supermarkets into supercentres. In his address to the Annual General Meeting held on 20 November 2006, John Fletcher, CEO, announced a new strategy for Coles Myer Limited:

The formation of an integrated supermarkets, liquor, convenience and general merchandise business providing the everyday shopping needs of Australians under one icon brand.

Different formats to suit different shopping occasions, yet all with a consistent customer experience operated under one trusted brand of Coles. This is a model we have seen Tesco - the market leader in the UK - use so effectively...

²⁵ Ibid.

²⁶ Coriolis, *Chart Watch Q2 2006, Part 2*, 2006.

²⁷ Ibid.

...The introduction into Australia of supercentres is an exciting element of our new strategy. These are large stores, roughly three times the size of a supermarket. They are the fastest growing form in the world, the one-stop shop for your food, general merchandise and apparel shopping. We fortunately enjoy a real estate advantage over our competitors with a number of our existing supermarkets co-located with K-mart stores. These will provide the platform for our supercentre format. In time we expect to have around 80 supercentres nationally.

97. Both Foodstuffs and Woolworths have suggested that overseas evidence is that for supercentres to be successful, it is necessary for groceries to be sold at low prices. In its Memorandum on behalf of Foodstuffs, CRA stated:

To be successful, supercenters require a large volume of sales per foot of store space, generated by high levels of store traffic and large consumer radii. Consumers must be willing to sacrifice locational convenience, quality, service and store environment for lower prices and large assortments. In order to induce such consumer behaviour supercenters must undercut the price of traditional supermarkets; price leadership is considered a mandatory requirement for success. Supercentres can achieve this by utilising cost advantages established in the discount merchandise industry.

98. Of overseas supercentres, Wal-Mart, in particular, operates at every day low prices. Hausman and Leibtag²⁸ state that Wal-Mart offers many identical food items at an average price about 15%-25% lower than traditional supermarkets.
99. However, Dimasi (for Woolworths) notes that other supercentres do not go to market with such an emphasis on lowest prices. Rather, their emphasis is on the breadth of their offer. Dimasi cited Costco, Carrefour and Tesco as falling into this category.
100. A common issue in the literature and in submissions by the applicants is that the successful introduction of the supercentre concept requires local circumstances be taken into account. The inability of Carrefour and Wal-Mart (initially) to find success with the European hypermarket model in the United States bears this out.
101. Coriolis suggested that 'Lesson 1' to be learned from Wal-Mart's move into groceries is that you do not get it right first time. Applying that to Warehouse Extra, it stated²⁹:

No matter how much homework they have done or how many stores they have visited around the world, we expect The Warehouse will have similar experience and tinker with its concept on an ongoing basis as it develops more experience with the concept in the New Zealand market.

MARKET DEFINITION

102. The Act defines a market as:³⁰

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

103. For the purpose of competition analysis, the relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry would be able to impose at least a

²⁸ Jerry Hausman and Ephraim Leitag, *Consumer Benefits from Increased Competition in Shopping Outlets: Measuring the Effect of Wal-Mart*, MIT and Economic Research Service, US Department of Agriculture, October 2005.

²⁹ Coriolis, *Chart Watch Q2 2006*, 2006.

³⁰ Commerce Act 1986, s 3(1A).

small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the dimensions of the market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

104. In Decision 448 the Commission concluded that the relevant markets for the consideration of the application were the following:
- the market for the retailing of grocery items in supermarkets, incorporating regional markets not less than 5 km in radius; and
 - the national market for the wholesale supply of groceries.
105. In reaching that conclusion the Commission took into account the following:
- A principal reason why supermarkets attract consumers is the one-stop shop concept. While it may be that the individual goods purchased by the consumer are sometimes available at lower prices in non-supermarket outlets (including specialist and convenience stores), the time and inconvenience involved in shopping at multiple outlets mean that these outlets do not usually provide consumers with a satisfactory substitute for a supermarket. Accordingly, supermarkets fall within a discrete market, separate from specialist and convenience stores.
 - The distance consumers are typically willing to travel to an alternative supermarket to avoid a SSNIP can vary, but 5 km is a reasonable approximation. This was a common view of interested parties and was reasonably consistent with how markets were defined by competition agencies abroad.
 - It was not necessary to incorporate a time dimension in the market in order to assess the competition effects.
106. The Commission recognises that the present applications relate not just to the wholesaling and retailing of groceries but also to the retailing of general merchandise and the retailing of stationery.
107. The retailing of general merchandise is the principal business of The Warehouse operating out of its “Red Sheds”.
108. In recent years, supermarkets have included an increasing number of general merchandise items in their offerings. It is now common to find a limited range of general merchandise items such as dinnerware, towels, toasters, DVD players and televisions on supermarket shelves. Foodstuffs advised the Commission that presently general merchandise accounts for around [] of its total retail sales []. Woolworths, in its application, states that it sells a limited range of general merchandise products in convenience categories in its supermarkets, and that these categories are generally of such a nature that most consumers would consider them to be part of their normal grocery shopping (e.g. batteries, light bulbs and buckets).
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109. The Commission is of the view that as the range of general merchandise offered by supermarkets is limited and any aggregation that would occur in respect of general merchandise if either applicant were to acquire The Warehouse is likely to be minimal. In addition, there are also a number of other substantial general merchandise retailers, such as Briscoes, Farmers and K-Mart. The Commission considers that in these circumstances competition concerns would not arise from either acquisition and, therefore, for the purpose of considering the present applications it is neither necessary to define specific general merchandise retailing markets, nor to undertake further analysis of these markets.
110. While The Warehouse is an important retailer of stationery with 43 Warehouse Stationery stores located across New Zealand, there are a range of other stationery retailers competing with it. Both Foodstuffs and Woolworths retail a limited range of stationery items in their supermarkets, but the aggregation that would arise from either acquisition in this respect would be minimal.
111. In these circumstances the Commission considers that no competition concerns arise, and therefore, it is neither necessary to define specific stationery retailing markets, nor to undertake further analysis of these markets for the purpose of considering the present applications.

Grocery Retailing

Product Market

112. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market.
113. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.
114. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change to their relative prices.
115. In this case, the Commission is required to define markets that best allow it to test the competition effects of the proposed acquisition of The Warehouse by either Woolworths or Foodstuffs. Both Woolworths and Foodstuffs retail groceries through supermarkets. The Warehouse in its Red Sheds retails a limited range of groceries (alongside its general merchandise). Of particular relevance, however, is The Warehouse is also in the early stages of developing supercentres that retail a much wider range of groceries than found in its Red Sheds, as well as general merchandise.

The Views of the Applicants

116. In its application, Woolworths noted how the Commission defined markets for the retailing of groceries in Decisions 438 and 448, but stated that it considered that “adopting a narrow supermarket market is too conservative”³¹. It considered that competition occurs across a spectrum of formats, including supermarkets, convenience and specialty stores. It pointed out that one third of

³¹ Woolworths application, para 28.

all meat, produce, seafood and bakery retail purchases are from non-supermarket retailers. It considered that specialist retailers do impose, collectively, a material constraint on supermarkets.

117. Woolworths also stated, however:³²

Notwithstanding Woolworths' views (and reserving to Woolworths the right to continue to argue for a broader market definition), Woolworths considers the scope of the product market is not a determinative factor in the analysis and has, accordingly, used the Commission's previous product market definition in this application. However, consistent with the Commission's own practice and the High Court's decision in *Brambles*, the material constraints imposed by specialist retailers must be factored into the competition analysis.

118. Foodstuffs, in its application, identified without dissent the market definitions used by the Commission in Decision 448. It noted that it is possible that similar geographic markets to those used for supermarkets exist for the sale of general merchandise, although it considered that it is more likely that separate markets exist for individual general merchandise items.

Commentary

119. The retailing of groceries has a number of critical elements to its success. Price is one of them, but factors associated with consumer convenience are also extremely important. These factors include the range of products carried, the helpfulness of staff, the check-out waiting time, the store ambience, the store location, the availability of car parks, and so on.

120. Grocery retailers can be differentiated by their ability to meet consumers' requirements for price and service. For instance, corner dairies and service stations are likely to be able to offer a convenient service to some consumers, but are most unlikely to be able to offer the range of products and the generally low prices available in supermarkets. On the other hand, supermarkets are unlikely to provide the range or level of customer assistance which is often available for specific products in specialty stores.

121. The grocery buying patterns of supermarket shoppers can be broadly divided into the "main shop" and the "top-up shop". The main shop is the regular shopping trip undertaken on, perhaps, a weekly basis where the consumer seeks to buy most of his or her projected requirements for the week. The top up shop is where the consumer makes additional small purchases between main shops.

122. For the main shop, in particular, the principal attraction for consumers of supermarkets is likely to be that they offer a one-stop shop. For the reasons explained by the Commission in paragraphs 42 to 47 of Decision 448, a one-stop shop allows groceries to be purchased at a much lower total transaction cost than would be the case if the same groceries were purchased at a range of specialist stores. Transaction costs include eftpos transaction fees, transportation costs, search costs and, probably most importantly, the value the consumer places on his or her time when shopping for groceries.

123. In reaching the conclusion in Decision 448 that there was a discrete market for the retailing of groceries in supermarkets, the Commission took into account a submission it received from Foodstuffs in November 2001. In that submission Foodstuffs' disputed the view expressed by Progressive that the appropriate

³² Woolworths application, para 38.

market was that for the supply of FMCG (fast-moving consumer goods) to consumers and that, in that market, supermarkets were merely one player along with stores such as Starmart and The Warehouse (pre-Warehouse Extra). Foodstuffs stated:³³

Foodstuffs' view is that the FMCG market definition is inappropriate. As a matter of commercial reality, few consumers who purchase FMCG from a supermarket as part of a main order shop would instead acquire those goods from a number of specialist or convenience stores in the event that supermarkets imposed a SSNIP. As stated by the Commission (in Decision 438), customers travel to supermarkets because they provide one stop shopping at low or moderate prices for a wide range of items. Convenience and specialist outlets by their nature do not meet consumer needs in this area. Foodstuffs is not aware of any market in the developed world where the shopping trip is more a visit to a collection of specialist retailers than one trip to a supermarket.

124. The Commission is not aware of significant changes since 2001 which affect the factors consumers take into account when choosing the type of retail outlet.
125. The Commission recognises that individual supermarkets may have regard to the presence of specialty stores in their vicinity (for instance a Mad Butcher, an Asian supermarket, or a greengrocer) and that the presence of these specialist stores can affect how a supermarket prices the products they have in common. For it to do otherwise would risk it losing some business (particularly from those customers engaged in top-up shopping.) However, in general the products in any such specialist stores would represent a very small proportion of the total products carried by a supermarket. The view that much greater competition to supermarkets comes from other supermarkets rather than specialty stores is supported by the fact that Foodstuffs and Woolworths monitor each other's prices on a detailed and regular basis, [].
126. This approach is consistent with that of competition agencies in other jurisdictions. For instance, in December 2001, the Federal Trade Commission (FTC) in the United States of America considered the merger of two supermarket chains, Koninklijke Ahold NV and Bruno's Supermarkets Inc.³⁴ In that case, the FTC considered the relevant product market to be the retail sale of food and grocery items in supermarkets on the following basis:

Supermarkets provide a distinct set of products and services for consumers who desire one-stop shopping for food and grocery products.

Supermarkets carry a full line and wide selection of both food and nonfood products (typically more than 10,000 different stock-keeping units ("SKUs")), as well as an extensive inventory of those SKUs in a variety of brand names and sizes. In order to accommodate the large number of non-food products necessary for one-stop shopping, supermarkets are large stores that typically have at least 10,000 square feet of selling space.

Supermarkets compete primarily with other supermarkets that provide one-stop shopping for food and grocery products. Supermarkets base their food and grocery prices primarily on the prices of food and grocery products sold at nearby supermarkets. Most consumers shopping for food and grocery products at supermarkets are not likely to shop elsewhere in response to a small price increase by supermarkets.

³³ Philips Fox, *Submission to the Commerce Commission prepared on behalf of Foodstuffs (Auckland) Limited*, undated but received by the Commission in November 2001.

³⁴ US Federal Trade Commission, *Koninklijke Ahold N.V. and Bruno's Supermarkets, Inc.*, File No. 011 0247, Docket No. C-4027.

Retail stores other than supermarkets that sell food and grocery products, such as neighbourhood "mom & pop" grocery stores, limited assortment stores, convenience stores, specialty food stores (e.g., seafood markets, bakeries, etc.), club stores, military commissaries, and mass merchants, do not effectively constrain prices at supermarkets. The retail format and variety of items sold at these other stores are significantly different from that of supermarkets. None of these other retailers offer a sufficient quantity and variety of products to enable consumers to one-stop shop for food and grocery products.

127. The Competition Commission in the United Kingdom has adopted a similar approach to that of the FTC. In its 2000 inquiry into supermarkets³⁵, the Competition Commission concluded that the relevant product market was one for "one-stop shopping" in stores over 1,400 square metres. The Competition Commission also concluded that while it believed that in some instances there would be competitive pressure from outside the one-stop shopping market from different types of store as well as smaller stores, this was not sufficient for it to widen its market definition. The Competition Commission confirmed this view in 2003 when it assessed the competition effects of a number of proposed supermarket mergers including that of Safeway plc and Asda Group Limited.³⁶
128. The Australian Competition and Consumer Commission (ACCC) also adopts this approach to market definition in respect of supermarkets. In a recent assessment of Woolworths Limited's proposed acquisition of 22 Action stores and development sites, the ACCC considered:³⁷
- the local markets surrounding each of the stores Woolworths proposes to acquire. In these markets supermarkets compete to provide a bundle of goods and services to consumers within a limited geographic area.
- It further stated that:
- For the purposes of examining the relevant retail markets, the ACCC considers the relevant retail product market to be supermarkets. Note that this definition excludes specialty retailers such as bakers, butchers, fruit and vegetable stores, as well as convenience stores.
129. Different types of grocery outlets are starkly differentiated. The Commission also recognises that, to some extent, individual supermarket banners are also differentiated. The Commission has considered whether all supermarket banners and the Warehouse Extra fall within the one product market.
130. The Warehouse Extra supercentres offer a range of grocery products which is generally equivalent to those carried by supermarkets. The number of SKUs (stock keeping units) offered by each of the banner groups is shown in Table 6.

³⁵ Competition Commission, *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, 10 October, 2000.

³⁶ Competition Commission, *Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc: A report on the mergers in contemplation*, 18 August 2003.

³⁷ Australian Competition and Consumer Commission: *Public Competition Assessment on Woolworths Limited Proposed Acquisition of 22 Action Stores and Development Sites*, 19 October 2005.

Table 6: Number of Grocery SKUs Offered by Each Market Participant

Company	Banner Group	Banner type	Number of Grocery SKUs
Foodstuffs	Pak n Save	Discount	[]
	New World	Full Service	[]
Woolworths	Countdown	Discount	[]
	Woolworths/Foodtown	Full Service	[]
The Warehouse	Extra stores	Discount	[]

Source: Foodstuffs, Woolworths, The Warehouse

131. Supermarket services can be differentiated in several different ways: for example, by location (spatially), by the combined price and quality of the service, or by convenience through breadth of offer. This means that no two supermarkets are likely to be perfect substitutes in the eyes of a given consumer. Each consumer is likely to have his or her own view on the relative importance of price, convenience and the other components of service, and the trade-offs between them. (This suggests that individual supermarkets are likely to possess at least a small degree of market power, in that they can raise price above marginal cost and still retain a substantial proportion of their customers.)
132. Pak'n Save and Countdown tend to be positioned as discounters at one end of the differentiation spectrum (although Countdown has recently enhanced its service offering), while Foodtown, Woolworths and New World are generally characterised as full-service banners and are closer to the other end of the spectrum.
133. Warehouse Extra stores have adopted a model that is different to the Foodstuffs and Woolworths banners. While, at least at this stage, they are not the lowest price stores, their principal point of differentiation is the breadth of their product range. They have a full range of groceries and of general merchandise products in the same store, thereby providing a broader one-stop shop appeal than is provided by traditional supermarkets.
134. Notwithstanding the points of differentiation between different supermarkets and supercentres, the Commission is of the view that for groceries they are providing sufficiently similar services to make them substitutable for each other for most consumers in most circumstances.

Conclusion on Product Markets

135. The Commission is satisfied that the principal factors relevant to product market definition have not changed materially since Decision 438 (13 July 2001) and Decision 448 (14 December 2001). The major development has been the entry of The Warehouse with its Extra stores. These stores provide grocery offerings that are broadly similar in range and associated services to those that are provided by supermarkets.
136. While Warehouse Extra and the individual banners of Foodstuffs and Woolworths are differentiated to some extent, the Commission considers that they are sufficiently substitutable one for another for them to be placed within the same product market for the purpose of the competition analysis in this case.

137. The Commission also concludes that specialty and convenience stores are not sufficiently substitutable for enough supermarket shoppers for them to be placed within the same product market as supermarkets. In arriving at this conclusion the Commission has had regard to information provided during the course of its consideration of the current applications (particularly from Woolworths), and also to:
- the factors outlined in Decisions 448 and 438;
 - the submission from Foodstuffs in 2001;
 - the conclusions of competition authorities internationally; and
 - the tacit acceptance of this approach by Foodstuffs in its application and the view by Woolworths that it is not a determinative factor in the analysis.
138. The Commission concludes that for the purpose of assessing the competitive effect of the proposed acquisition, the relevant product market is that for the retailing of grocery items in supermarkets. Grocery sales made by the Warehouse Extra fall within this product market.

Geographic Markets

139. In Decision 438 the Commission based its assessment of the geographic scope of each supermarket market on an assessment of how far consumers would be prepared to travel in the event that a hypothetical single supermarket in one area raised its prices by 5% (i.e. the lower end of the range of the percentages used in the SSNIP test). Using a model developed by NZIER (for Progressive), the Commission calculated 5% of the value of the average shopping basket for the highest spending customers. The Commission then considered how far consumers would be likely to travel to avoid paying that amount, taking into account both motor vehicle costs, and the time cost and inconvenience of the travel involved.
140. Based on this approach, the Commission adopted as the starting point for its competitive analysis geographic markets covering the region within 5 km of each supermarket. Thus, it placed within the one market two supermarkets that are within 5 km of each other. It considered that, in general, sufficient customers of one supermarket, faced with a 5% price increase, would switch to an alternative supermarket within 5 km of the first to make the price increase unprofitable for the original supermarket.
141. The Commission recognises that there are a number of factors that could cause this broad approach to vary between individual regions. The willingness of customers to travel to avoid a SSNIP may be affected by such matters as the state of the roads, traffic flows and the level of motor vehicle ownership. The population density in different parts of the region can vary, and it may be that there are relatively few customers who live between the supermarkets (and therefore can switch relatively readily). In addition, supermarkets are differentiated, so that some consumers may consider a “full service” supermarket not to be an adequate alternative to a “discount” supermarket, notwithstanding that they are within 5 km of each other. Even within a 5 km area consumers are more likely to consider neighbouring supermarkets as more satisfactory substitutes than supermarkets that are 3, 4 or 5 km distant. Nevertheless, the Commission considered that 5 km provided a reasonable

starting point for defining the geographic scope of each market. It is also broadly in line with the bases used in overseas competition jurisdictions, and both applicants have accepted it as a starting point (albeit that Woolworths had reservations). The implication is that there are a large number of local supermarket markets in the country.

142. Woolworths, in its application, noted that in the past the Commission has examined local geographic markets, but that in this case true competition in both retail and wholesale food, liquor and grocery markets is driven by the national decisions of Woolworths and Foodstuffs. Further it stated that there is no available data to reliably or usefully model likely competitive impacts in local markets. It said that, as a result, the competitive impacts are invariably the same throughout New Zealand and that therefore the Acquisition falls to be properly analysed on a national basis.
143. The Commission does not agree with this view. It is required to define markets in a way that best allows it to analyse the competitive impact of the case in question. In this instance, The Warehouse has begun retailing groceries in supercentres in Mt Wellington and Whangarei and has announced its intention to do so in the foreseeable future at Te Rapa and in a number of other regions. It is these local markets that would have most to lose if the competition arising from the supercentres were to be foreclosed by either acquisition. Consequently, the Commission considers that it is appropriate to adopt local geographic markets to assess whether there would be this loss of competition.
144. Woolworths in its application also said:
- (E)ven if the Commission determined to examine local markets, Woolworths considers each local market would be broader than the 5 km starting point previously used by the Commission. Supermarkets themselves are spatially differentiated – that is, not every supermarket creates the same circle of constraint. The result being that in many locations there is a chain of overlapping supermarkets creating a wider market than one purely focussed on discrete local areas.
145. The broader market created by overlapping supermarkets’ catchments was recognised by the Commission in Decision 438 when it said:³⁸
- Where there are competing stores within 5 km distances, by the chain of substitution these stores will fall within the one market and the market will therefore be greater than 5 km in dimension.
146. The Commission emphasises that the role of market definition is to provide a framework that best tests the competitive effects of an acquisition. A principal focus in this case is the competitive impacts of the proposed acquisitions on those consumers who have the practical option of shopping at a Warehouse Extra store for their supermarket shopping. It is anticipated that these consumers will mainly reside within 5 km of the store, although the Commission recognises that consumers who wish to take advantage of buying both groceries and general merchandise in the one shop may be prepared to travel further than 5 km. However, the Commission considers that geographic markets defined by travelling distances of 5 km from each actual or prospective Warehouse Extra store generally provide an appropriate focus in this case.

³⁸ Decision 438, paragraph 68.

147. As the Warehouse Extras will be set up in [], each will face competition from both Foodstuffs' and Woolworths' supermarkets within its 5 km catchment. Further, as there are no other supermarket operators in New Zealand, broadening the geographic boundary would not increase the number of firms in the market.

148. Woolworths has suggested that:³⁹

By assuming that only supermarkets within 5 km of each The Warehouse Extra store assert competitive constraint, the Commission fails to appreciate:

- a) The fact that (even at current prices) many of the customers that reside within some limited region around a store may at current competitive prices already shop at other stores outside that region, and often at stores that are within 5 km of (and may be closer to) where they live or work than to the subject store.
- b) That consumers would react to supra-competitive price increases in one of two ways:
 - New customers would commence shopping outside the 5 km reference area; and
 - Customers who already shop outside the area for some purchases will increase their purchases outside the area.

149. The Commission recognises that, as with most markets defined for the purpose of competition analysis, there are not usually clearcut boundaries. Some consumers living within a 5 km circle will shop outside the circle. Equally some consumers from outside the circle may find their local supermarkets unsatisfactory and will be prepared to travel into the circle. These factors are taken into account in the Commission's competition assessment.

Conclusion on Geographic Markets

150. The Commission has concluded that it is appropriate to use as a starting point for defining the geographic dimension of the relevant local markets a line representing a travelling distance of 5 km from each actual and prospective Warehouse Extra. The Warehouse has commenced its supermarket operation in Mt Wellington and Whangarei, and is about to have an Extra conversion rolled out in Te Rapa. The Warehouse has plans to []. There is also credible potential for supercentres in other regions, albeit these regions have not been specifically identified at this time.

The Wholesale Supply of Groceries

151. Coriolis estimated in November 2005 that Foodstuffs and Woolworths represent about 78% of retail food purchases in New Zealand.⁴⁰ Clearly, access to supermarket outlets can be a critical factor in the wholesaling of food and non-food grocery items.

152. Consideration of the proposed acquisition requires an assessment of the market power that would be held by the merged entity as buyers in the wholesale market. The Commission considers that this can be analysed fully using a national market. Most suppliers supply nationally and there do not appear to be

³⁹ Woolworths' submission entitled "Summary submission in support of Application for Clearance to acquire The Warehouse Group Ltd", received by the Commission on 1 June 2007.

⁴⁰ Coriolis Research, *Mapping the Structure of the New Zealand Food & Beverage Industry*, November 2005.

important differences in the way the market operates in different parts of the country.

Conclusion on Market Definition

153. The Commission concludes that the relevant markets for the consideration of the applications are:
- the markets for the retailing of grocery items in supermarkets, incorporating local markets not less than 5 km in radius from The Warehouse Extra stores in:
 - Mt Wellington, Whangarei and Te Rapa;
 - [];
 - other regions where there is a credible potential for a rollout of a supercentre; and
 - the national market for the wholesale supply of groceries.

FACTUAL AND COUNTERFACTUAL

154. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a comparative judgement considering the likely outcomes between two hypothetical situations, one with the acquisition (the factual) and one without (counterfactual).⁴¹ The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

155. Foodstuffs and Woolworths have separately advised the Commission of their plans for The Warehouse should they be the successful purchaser.

Foodstuffs

156. In its application, Foodstuffs advised the Commission that it believes that the proposed acquisition would enable it to significantly enhance its general merchandise and apparel offerings. By combining its existing buying power with that of The Warehouse it considers that the combined entity would be able to acquire general merchandise and, to a lesser extent, grocery items at lower prices. It has stated that this would render Foodstuffs more competitive with Woolworths and benefit both Foodstuffs cooperative members and customers.
157. Foodstuffs stated in its application that if its proposal were to proceed, it might consider developing the supermarket business of The Warehouse, and consider developing new approaches to retailing both grocery and general merchandise. Its preliminary view was that []:
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⁴¹ Air New Zealand & Qantas Airways Ltd v Commerce Commission (No.6), (2004) II TCLR 347 at 366..

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158. In subsequent discussions, Foodstuffs told the Commission that it considered that it currently has a slight buying disadvantage in comparison to Woolworths, primarily due to Woolworths' size in Australia and its ability to negotiate trans-Tasman buying relationships.⁴³

159. Foodstuffs also advised the Commission that it started increasing its general merchandise offerings in its supermarkets approximately three years ago and these now make up approximately [] of all goods sold in its supermarkets.⁴⁴ Foodstuffs noted that general merchandise offers higher margins than standard groceries, and supermarkets have the ability to use their existing stores' 'footprints' to sell more goods.

160. The Commission notes that Foodstuffs has suggested that if it acquired The Warehouse, []. However, the Commission understands that no firm decisions have been made by Foodstuffs in this regard. In addition, the Commission considers that Foodstuffs may have some incentives not to develop the concept if, for instance, it would result in the cannibalisation of its existing supermarkets. []with 100% of the shares (which it is seeking clearance to acquire) it would still be a Foodstuffs' controlled operation. Accordingly, the relevant factual scenario for analysing the possible competitive impact is Foodstuffs gaining effective control of existing and future The Warehouse stores. This means that The Warehouse Extra would cease to be an independent operator of supercentres.

Woolworths

161. In its application Woolworths stated that it considers that the acquisition would allow it to:

- reduce The Warehouse's general merchandise unit costs by allowing Woolworths to jointly procure general merchandise products for both Australian and New Zealand stores;
- expand The Warehouse's general merchandise product range by bringing certain Big W products into The Warehouse stores;

⁴² Tony Carter, Managing Director, Foodstuffs (Auckland) Limited at an interview with Commission staff on 14 March 2007.

⁴³ Ibid.

⁴⁴ Ibid.

- selectively consider opportunities to change usage of certain stores into other formats, including supermarket combinations; and
 - seek out New Zealand suppliers and encourage greater participation from them both in The Warehouse and in Woolworths' Australian formats.
162. Woolworths submitted that the proposed acquisition would allow it to operate the same retail structure as it does in Australia. In Australia, Woolworths is a general merchandise retailer with its 'Big W' outlets as well as a supermarket operator. It currently does not participate in general merchandise in New Zealand, except to the extent that it is a modest component of the product range in its supermarkets.⁴⁵ It believes that acquiring The Warehouse would provide it an effective, timely and sustainable point of entry into New Zealand general merchandise. It would continue to operate The Warehouse stores as general merchandise stores, and with its presence in Australia it would be able to create a number of synergies.
163. Woolworths advised the Commission that
[

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164. Woolworths advised that one of the main impediments to it establishing its general merchandise format in New Zealand was the availability of suitable sites. Woolworths stated that the previous owners of its supermarkets, Progressive,
[

]. However, it considers that entry through acquisition is the most efficient and timely entry method into general merchandise in New Zealand. With entry, it would then replicate its existing retail structure in Australia. In addition, Woolworths considers that with its knowledge and experience it has the ability to improve the existing offerings of The Warehouse.
165. Woolworths stated that it is aware that The Warehouse has plans to develop approximately 15 Extra stores although it did not know which stores The Warehouse had specifically identified (apart from Sylvia Park, Whangarei and Te Rapa). Woolworths had no established plans for continuing either the existing stores or the further roll out of The Warehouse's supercentre concept.
166. The Commission notes that, irrespective of what future operational and development decisions are made, in the factual scenario The Warehouse would be owned and controlled by Woolworths, and would therefore not be a competitor and independent operator of supercentres in the relevant markets.

⁴⁵ In addition, Woolworths operates a number of consumer electronic stores in New Zealand (under the Dick Smith Electronic brand).

⁴⁶ Tom Pockett, Finance Director, Woolworths Limited, at an interview with Commission staff on 14 March 2007.

Conclusions on the Factual Scenario

167. The Commission has reviewed the current intentions of Foodstuffs and Woolworths in respect of the Warehouse should either of them acquire it. Both involve maintaining and possibly developing the main general merchandise business conducted by The Warehouse. Their plans, insofar as the supermarket operations are concerned, are yet to be finalised, but there is nothing sufficiently different that would require the formulation of separate factuals for each applicant.
168. Under the factual, The Warehouse would be under the ownership and control of Foodstuffs or Woolworths. In either case, compared with the present situation there are likely to be some efficiencies achieved in the buying of general merchandise and groceries. It is possible that the Extra concept might continue to be trialled. Significantly, for the purposes of the Commission's considerations, The Warehouse Extra would cease to be a third competitor and independent operator of supercentres (or some other form of grocery retailing) in the supermarket market.

Counterfactual

169. The counterfactual is the Commission's view of the likely scenario if the acquisition being considered does not proceed, and is the benchmark against which any changes arising from the proposed acquisitions are assessed.
170. When making this assessment, the Commission recognises that future scenarios may include the existing owners continuing to control the target entity, or other parties that are known to be interested in purchasing the target entity, if neither of the applicants were to proceed. When other parties are interested, and do not already have a clearance under the Act to make the purchase, the Commission is required to consider the possibility that s47 of the Act could prevent the other interested party(s) from making the purchase. If this were the case, that party would not be included as a factor in the counterfactual assessment.
171. At present, both supermarket companies have applied to the Commission for clearance to acquire The Warehouse. The Commission considers that the competitive impact of either of the applicants owning The Warehouse is similar. Thus, if the situation were that one of the applicants were prevented from purchasing The Warehouse, because to do so might be in contravention of s.47, it would be unlikely that the other applicant could proceed in its place. Consequently, Woolworths acquiring The Warehouse is not the counterfactual to Foodstuffs making the acquisition, and vice versa.

Views of the Applicants

172. Both applicants claimed that the Warehouse Extra concept would not provide effective competition to their supermarkets in the future because the concept is not viable. In their view, the Extras will not achieve the scale necessary to allow them to offer low grocery prices, that without low prices they will not attract sufficient customers to achieve the 'halo effect', and that results to date confirm that the business is not sustainable
173. Foodstuffs stated its position as follows:⁴⁷

⁴⁷ Letter from DLA Philips Fox to Commission dated 18 May 2007.

Foodstuffs' view is The Warehouse is not currently, nor in the future likely to be, a *substantial* competitive threat in a national market or specific regional markets as an existing retailer or new entrant for the following reasons:

- Many Warehouse store are not suitable for conversion into fully converted Warehouse Extra stores because of existing site constraints such as size and parking.
- Lack of buying power comparative to Foodstuffs.
- Lack of retail grocery expertise particularly in the management of key categories such as fresh produce.

174. Foodstuffs also considers that it is unlikely that The Warehouse will transfer its success in general merchandise to grocery at a national level, or in local markets, without significant price leadership on grocery lines and without achieving much greater scale than seems likely at present.

175. Woolworths' view was as follows:⁴⁸

The evidence on record demonstrates:

- In the foreseeable future WHS is likely to abandon its Extra roll out.
- In all markets with similar characteristics to New Zealand, successful hypermarkets offer lower prices than conventional supermarkets.
- The Warehouse Extra will not be a price leader or price competitive and will not attract price sensitive customers.
- The Warehouse Extra will not attract service sensitive customers because it is "low service" from a customer's perspective.
- There is no tacit collusion between the supermarkets today. Nor is there any evidence that tacit collusion is likely to occur in the future. Furthermore, there is no evidence that WHS *would undermine* any such tacit collusion (even were it to exist).

The Commission's Assessment of the Counterfactual

176. In determining the appropriate counterfactual, the Commission has given careful consideration to the information contained in submissions from the applicants, from independent commentators and from international papers that discuss the supercentre concept. The Commission must assess two likely scenarios: the likely state of competition if the proposed acquisitions proceed with the likely state of competition if the proposed acquisitions do not proceed (the counterfactual). The likely state of competition is that The Warehouse will continue to operate its Extra format for []. It will retain its [] sites available for supermarket retailing, its landbank, its distribution infrastructure and its general merchandise focus.

177. The applicants appear to argue for a very detailed scope for the Commission's assessment of the counterfactual and invite the Commission to determine whether The Warehouse Extra concept will succeed or remain viable. The Commission considers that it is not appropriate or possible to undertake a detailed assessment of the likely success of The Warehouse Extra supercentre concept. In determining the appropriate counterfactual the Commission considers that it should have regard to The Warehouse's stated plans for rolling out supercentres, the resources it has to achieve these plans, and the period for which the supercentre concept will be trialed. That is the likely competitive state if the proposed acquisitions do not proceed. The Commission is of the view that

⁴⁸ Para 2.1 of Woolworth's Submission in response to Commerce Commission letter dated 15 May 2007.

it is for the markets to determine whether that venture will succeed but notes that, if The Warehouse Extra supercentre concept is successful, the implications for grocery retailing in this country could be substantial.

178. In many respects the position is similar to that argued in *Qantas/Air New Zealand v Commerce Commission*. In that case the airlines argued that the New Zealand domestic airline market could accommodate only one full service airline and one low cost carrier. The Court discussed the position:⁴⁹:

The appellants argue that the New Zealand main trunk market could not support three airlines. Dr Tretheway said New Zealand routes can support only one FSA and one LCC. This influenced him to the view that the proposed Alliance would not be harmful for competition in the New Zealand main trunk market. However, there was no empirical data put forward to support the claim that the market could only support two airlines. As Mr Goddard submitted, that view appears to rest on the history of entry in New Zealand markets to date, the current profit levels of incumbents and on analogies with the Australian experience. In our view, such information does not enable any conclusions to be safely reached as to the number of players which the New Zealand main trunk market would accommodate and we do not think the Commission can be criticised for proceeding on that assumption. We are sympathetic to the view that, in the absence of empirical data which would permit a conclusion to be safely reached, it is for the competitive process, not the Commission or the Court, to determine the number and identity of participants in the market.

179. In this case there is no reliable empirical data to support the proposition that The Warehouse Extra will not succeed. The Commission considers that the available evidence indicates that The Warehouse will continue with its approach. Importantly there is the additional factor that The Warehouse has unique attributes that place it in a position in the counterfactual as the only competitor to the two incumbents in markets where it is operating or about to open and the only potential competitor in other local markets.

180. In response to entry by The Warehouse, Woolworths
[

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181. The Commission recognises that, as the applicants have emphasised, scale is very important to supermarkets. This is discussed further in the Entry Conditions section below. However, the Commission considers that the scale argument has to be qualified in several ways:
- Scale and market concentration can lead to purchasing power and the ability of the purchaser to drive down the wholesale price paid for goods (i.e. the exercise of monopsony power). There is unease amongst suppliers over the buying power of the two supermarket companies. The entry of a significant third purchaser in the form of The Warehouse Extra is considered by some suppliers at least as being likely to lessen buyer power. Accordingly, they have an incentive not to set terms for Warehouse Extra that would prevent it from being viable.
 - In almost all markets a new entrant faces scale and other disadvantages initially that often result in losses in the early years. This is likely to diminish as the new entrant grows and becomes established. If the

⁴⁹ *Air New Zealand & Qantas Airways Ltd v Commerce Commission (No. 6)* (2004) 11 TCLR 347 at 378-389.

supercentre concept proves sufficiently viable to persuade The Warehouse to expand, the scale disadvantage would be lessened.

- The Warehouse has offsetting advantages. It has an existing distribution infrastructure (which it can utilise for food to some extent) and existing stores. Any disadvantage on scale may be offset by these economies of scope on the supply-side.
- The business model for supercentres does not rely on retailing of grocery items achieving the sort of return common to supermarkets; rather it depends on the halo effect being sufficient to carry the grocery activity. This is an economy of scope on the demand-side. Thus, the model may prove to be viable even if food were not profitable in its own right.

182. The applicants have suggested that in all markets with similar characteristics to New Zealand, successful supercentres offer lower prices than conventional supermarkets. They point out that Extra prices are above those of Pak'n Save, in particular.

183. The Commission recognises that Wal-Mart's supercenters do offer groceries at very low prices. However, as Dimasi (for Woolworths) notes, this is not a feature of all supercentre retailers.⁵⁰

Other retailers (Costco, Carrefour, Tesco, etc) do not go to market with such an emphasis on lowest prices. They are not aiming necessarily at a higher price point strategy or even ceding the low end of the market to Wal-Mart, but the main point of difference with their hypermarkets is breadth of offer.

184. In response to the point about the [], the Commission is of the view that it is not necessary for The Warehouse Extra to offer the lowest grocery prices in order to compete effectively with other supermarket groups. In a CM Research Customer Survey provided to the Commission in the past, prices rank between third (equal) and fifth in terms of customer performance. Location, parking and range were more highly ranked.⁵¹ It also may be the case that the results of The Warehouse Extra to date have been negatively affected by the proposals to acquire The Warehouse.

185. The Warehouse informed the Commission that it planned to test the supercentre concept in its Extra stores in Whangarei, Mt Wellington and Te Rapa for a period of []. This is the key point in establishing the counterfactual, and []. The period of [] is also of significant relevance to the counterfactual because in this period the Warehouse Extra stores will provide competition, even if ultimately the supercentre concept were to prove not to be viable.

186. The Commission has found that the evidence indicates that the concept has found wide-spread acceptance and success overseas. While it does not appear to have been as successful in Australia in the past, the Commission notes Coles' recent announcement of its intention to develop 80 supercentre stores in Australia.

⁵⁰ Memorandum from Dimasi to Woolworths, 17 April 2007.

⁵¹ Decision 448 at paragraph 46.

191. Competition benefits consumers by driving down costs and prices, encouraging innovation and productivity and increasing quality and choice. As competitors continually strive to undercut competitors or produce more diverse, innovative or better quality products, competitive markets will be characterised by uncertainty and change, manifested in shifting market shares and structures, changing pricing patterns over time and product innovation. These important benefits of competition provide the principal rationale for competition law in most advanced economies.
192. Nationally, and in the vast majority of local markets in New Zealand, there is a duopoly in the supermarkets sector. While the two major supermarket groups - Woolworths and Foodstuffs - each offer different banners, the Commission considers that the different banners within the same group do not constrain each other because they are under common ownership.
193. As a general rule of thumb, a merger that reduces the number of competitors from three to two is, *a priori*, likely to reduce levels of rivalry to the detriment of customers. This is the case even if one of the competitors is small but likely to become a stronger competitor in the future. The effect of a merger on the possibility of new entry and/or likelihood of new entry might itself contribute to a substantial lessening of competition, where a merger reduces or eliminates the competitive constraint represented by new entry. In examining the competitive effects of a merger it is important to consider the impact on both existing and future competition. A merger that significantly reduces the potential for new entry or expansion in the future may enable the merged firm to raise prices, reduce quality, choice, service and innovation and/or it may dampen the incentives of firms left in the market to compete vigorously and/or it may increase the ability and incentive of firms to co-ordinate their behaviour.

Present Competition in Relevant Markets

194. Currently, the Warehouse Extra stores are competing with Foodstuffs' and Woolworths' supermarkets in Mt Wellington and Whangarei. The Warehouse Extra store in Te Rapa will open later this year and, as discussed further below, has already had a competitive impact in that region.
195. Subject to a satisfactory performance of its initial stores, The Warehouse Extra [
-].
196. The extent of current competition provided by The Warehouse Extra stores is discussed below. While the Commission sees this competition as being important and is bringing with it significant consumer benefits, it also recognises that such competition will have been limited by two short-term factors:
- existing stores are in their formative stages, and it is widely-recognised that as a new concept for New Zealand, it will take some time before The Warehouse can test them sufficiently to know what works best in local conditions; and
 - for much of the time since the stores have been open, both Foodstuffs and Woolworths have each been seeking to acquire The Warehouse. It is possible The Warehouse's incentives to develop the Extra stores were

dampened while the outcome of the acquisition proposals is being decided and any new owner makes a decision on the future direction of the company. The acquisition proposals would also be expected to also distract senior management from the task of interpreting the performance of the Extra stores to date and adapting the stores to better meet customers' requirements.

Mt Wellington

197. The Warehouse opened its first Extra store on 8 June 2006 in the new Sylvia Park shopping centre. Also located in this shopping centre are a Pak'n Save and a Foodtown. Within a 5 km distance of the Extra supermarket are a Countdown at Mt. Wellington (900m from The Warehouse Extra), a New World at Panmure (2.9 km) and Foodtown Pakuranga (4.4 km). Further afield are other Foodtowns at Onehunga (6.5 km from The Warehouse Extra) and Greenlane (6.3 km), and a Pak'n Save in Glen Innes (5.8 km).
198. Table 7 shows the average weekly market share of each of the supermarkets in the Mt Wellington supermarket market from the time the Pak'n Save opened at Sylvia Park (The Warehouse Extra and the Foodtown stores opened there in June 2006) through to the week commencing 19 March 2007.

Table 7: Average Weekly Market Shares in the Mt Wellington Market from the Week Commencing 31 July 2006 through to the Week Commencing 19 March 2007

Supermarket	Average Weekly Revenue (\$)	Market share (%)
New World Panmure	[]	[]
Pak'n Save Sylvia Park	[]	[]
<i>Foodstuffs' total</i>	[]	[]
Foodtown Sylvia Park	[]	[]
Foodtown Pakuranga	[]	[]
Countdown Mt Wellington	[]	[]
<i>Woolworths' total</i>	[]	[]
Warehouse Extra	[]	[]
Grand Total	[]	100

Source: Market participants.

199. Table 7 shows that since opening, The Warehouse Extra store at Sylvia Park has captured around [] % of the total supermarket sales in the Mt Wellington market. The Commission notes that [] .
200. Figure 1 below gives a time series of market shares of the various supermarkets in the Mt Wellington local market from the week commencing 31 July 2006, when all three new supermarkets at Sylvia Park were open, through to the week commencing 19 March 2007.

Confidential Figure 1: Times Series of Market Shares in the Mt Wellington Market from the Week Commencing 31 July 2006 through to the Week Commencing 19 March 2007

[

] Source: Market participants.

201. Figure 1 shows that The Warehouse Extra's market share over this period has ranged mostly between [], except over the Christmas 2006 period when the store captured [] share of the market.
202. The Commission considers that []. It has been open for just on a year. The concept is still being tested and is expected to evolve over time. It may take [] before the testing stage is complete. Currently, public awareness of the concept is likely to be limited. The Sylvia Park shopping mall development has only been partially completed and is expected to attract much greater numbers once further stages of the development have been completed. In addition, the Commission considers that the shadow of the proposed acquisition of The Warehouse by Foodstuffs or Woolworths may have inhibited the development of the concept.
203. Nevertheless, the Commission considers that even at this stage the Warehouse Extra store has brought significant competitive benefits to grocery shoppers in the Mt Wellington market. It is part of the competitive mix which has seen the "full service" Foodtown store in Sylvia Park sell groceries at prices []
-].
204. Both Woolworths and Foodstuffs have suggested that relatively low prices in their Sylvia Park stores largely reflect competition between each other. However information provided to the Commission, and discussed below,

indicate that the incumbent supermarkets do develop new competitive strategies in response to the roll out of a new Warehouse Extra, notwithstanding that they are already competing with each other in that market. The Commission considers that an important reason for the relatively low prices and high services levels in the Mt Wellington region is the presence of the Warehouse Extra store.

Whangarei

205. The Warehouse rolled out its Extra format in Whangarei on 30 November 2006 in a store that was built in 2003, and subsequently converted from a standard Red Shed. In the Whangarei market is a Countdown supermarket (300 metres from the Warehouse Extra), a Pak'n Save (1 km), a Woolworths Kensington (2.8 km), a New World Regent (2.8 km), Countdown Tikipunga (5.8 km) and New World Onerahi (7 km).

206. Table 8 shows shows the average weekly market share of each of the supermarkets in the Whangarei supermarket market from the week commencing 27 November 2006 to the week commencing 19 March 2007.

Table 8: Average Market Shares in the Whangarei Market from the Week Commencing 27 November 2006 through to the Week Commencing 19 March 2007

Supermarket	Average Weekly Revenue (\$)	Market share (%)
New World Onerahi	[]	[]
New World Regent	[]	[]
Pak'n Save Whangarei	[]	[]
<i>Foodstuffs total</i>	[]	[]
Woolworths Kensington	[]	[]
Countdown Tikipunga	[]	[]
Countdown Whangarei	[]	[]
<i>Woolworths total</i>	[]	[]
Warehouse Extra	[]	[]
Grand Total	[]	100

Source: Market participants.

207. Table 8 shows that since opening, the Warehouse Extra store at Whangarei has captured around a [] % share of the market.

208. Figure 2 below illustrates a time series of market shares of the various supermarkets in the Whangarei market for the weeks commencing 27 November 2006, just before The Warehouse opened its Extra store in Whangarei, through to the week commencing 19 March 2007.

Confidential Figure 2: Times Series of Market Shares in the Whangarei Market from the Week Commencing 27 November 2006 through to the Week Commencing 19 March 2007

[

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Source: Market participants.

209. Figure 2 shows that The Warehouse Extra entered this market and initially captured around [] % of the market, increasing to around [] % over the Christmas 2006 period.
210. The Warehouse advised the Commission that the results at its Whangarei store []].
211. As with the Sylvia Park store, the Commission considers that the results of the Whangarei store to date are []. The main points to note are that: The Warehouse Extra store in Whangarei has been operating just over six months; and the concept is still being tested, and has not yet been fully promoted to consumers. In addition, the Commission considers that the shadow of the proposed acquisition of The Warehouse by Foodstuffs or Woolworths may have inhibited the development of the concept.
212. Nevertheless, the Commission considers that The Warehouse Extra store as it stands provides Whangarei consumers with a valuable alternative to incumbent supermarkets based on their current level of sales revenue. The Commission notes that the dollar value of sales achieved []. It has provided competition to date that can be expected to increase over time.

Te Rapa

213. The Warehouse has announced its intention to open its third Extra store in Te Rapa, Hamilton before Christmas 2007. The Warehouse advised the Commission that

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214. The store location is approximately 5 km north of the Hamilton city centre. In the city centre, there is a cluster of six supermarkets, variously controlled by Foodstuffs and Woolworths.

215. While the Te Rapa Warehouse Extra has not yet opened there is evidence that its prospective entry has brought positive competitive benefits. In a paper prepared by Woolworths in early 2006

[

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216. Thus, the threat of entry of a Warehouse Extra has invoked a competitive response, at least in terms of the formulation of strategies.

[

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217. The above markets are where The Warehouse has indicated to the Commission on a confidential basis that it has plans to roll out further supercentres in the next [

].

218. In each of these markets there are existing Woolworths and Foodstuffs supermarkets.

219. The Commission does not have direct evidence at this time that the prospect of a The Warehouse Extra store in these markets has impacted directly on competition at this stage. However, it considers that the experience at Te Rapa suggests that Woolworths and Foodstuffs respond in individual regions in anticipation of a The Warehouse Extra roll out. The Commission considers that [

] would be recognised by

Woolworths and Foodstuffs as potential roll out areas.

Other regions where there is a credible potential for a roll out of a supercentre

220. To date, The Warehouse has not committed itself to roll out supercentres in areas beyond those discussed above. However, the threat of entry invoked a

strong competitive response in Te Rapa, and it can reasonably be anticipated that a similar response has occurred in other areas where Foodstuffs or Woolworths perceive there to be a credible potential for a roll out. These firms are not aware of The Warehouse's detailed roll out plans.

Potential for New Entry into the Relevant Markets

221. An acquisition that results in the removal of a competitor from a market is unlikely to result in a substantial lessening of competition in a market if new entry into that market is relatively straightforward. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any impediments they might encounter should they try.

Barriers to Entry

222. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of market conditions that impede entry.

223. In Decisions 438 and 448, the Commission considered that there were significant barriers to entry for a potential new entrant into the supermarket market, and that de novo entry could not be relied upon to constrain the combined entity should it attempt to exercise market power. While The Warehouse has entered some supermarket markets since these decisions were made, it has the advantage of an established reputation, land bank and distribution network, and has the ability to achieve economies of scope. The Commission has been unable to identify any other firm with a similar ability to overcome entry barriers.

224. In Decisions 438 and 448, the Commission considered that the requirements needed to sustain entry in local supermarket markets include:

- access to suitable sites;
- resource consents; and
- economies of scale.

These matters are considered below. Also discussed are the potential for new firms to achieve economies of scope, and the likelihood of firms choosing to enter the markets.

Access to Suitable Sites

225. In its previous Decisions, the Commission considered that the availability of suitable sites is often a major impediment to entry, particularly in metropolitan areas. For example, sometimes supermarket chains have had to purchase several individual parcels of land to aggregate a sufficient area for a supermarket.

226. During the consideration of the current applications, industry participants indicated to the Commission that finding suitable sites is difficult. Woolworths advised that it

[
]. Woolworths submitted that
 []].

227. Foodstuffs advised the Commission that it has a land bank totalling [] sites. These sites [] have the potential to be used for future supermarket developments.
228. All industry participants noted that one of the major advantages for The Warehouse in entering the supermarket markets is its existing land holdings. The majority of the 85 The Warehouse stores are located in prominent retail areas. In addition, the Warehouse has vacant sites in []].
229. In respect of the availability of sites, Ian Morrice of The Warehouse advised the Commission that:
- New Zealand has become much more difficult in the last few years {to acquire sites} but the benefit that we have is that we've got most of the stores that we feel we need at this point in time. If you were starting out today in New Zealand and trying to replicate what we're doing it would be much, much more difficult.
- He added further:
- We couldn't have contemplated this if we didn't think that we didn't have a reasonably significant number of sites already. What we're attempting to do though is to take more money out of less space in general merchandise and effectively squeeze the food offer in and create the format rather than adding on more space.
230. The Commission considers that access to suitable sites represents a very significant barrier to entry.

Resource Consents

231. The Commission previously concluded that obtaining the necessary resource consents was a major barrier to entry. In many instances, obtaining consents for new supermarkets has taken several years. Resource consents are also required for the expansion of individual stores.
232. The Commission understands that the amount of time it takes to gain resource consents varies depending on the zoning of the land, the number of parties affected by the development, and the goals of local authorities. In general, the gaining of resource consents combined with the time for construction is perceived as a significant barrier to new entry.
233. As an example, in 2001 the Commission in Decision 438 found that Foodstuffs had been attempting for over 10 years to obtain the necessary resource consent for a new supermarket at Wairau Park on Auckland's North Shore, and that it had faced opposition from various parties including from its two (at that time) supermarket competitors. The Commission's Decision suggested that it might take a further two years for the new store to become operational. Foodstuffs subsequently completed construction of its Pak'nSave supermarket in mid-2005. However, the NZ Herald reported on 6 December 2006 that the \$40 million supermarket remains empty, that there was a large wire fence around the perimeter to secure the site, and that the planning dispute was dragging on. The general manager of property development at Foodstuffs is quoted as saying that he was confident that, when the store went back through the planning hoops, it would get approval. The issue has not been resolved since that time.
234. The Commission accepts that while Wairau Park may be an extreme example, it shows that the resource consents process in respect of supermarkets is not a

straightforward or timely one. Industry participants indicated that delays were compounded by the activities of the other existing supermarket chain that, almost by default, opposes any applications for resource consents.

235. The Commission considers that once a particular site has the appropriate classification for supermarket development, a supermarket building can be erected relatively quickly.
236. The Warehouse noted that a number of its sites were restricted in their ability to expand into groceries, such as its [] stores. However, these restrictions are to do with the existing leasing arrangements. The Warehouse advised that the 15 sites that it has identified that could be converted into the Extra format have the necessary resource consents in place.

Economies of Scale

237. The Commission in Decisions 438 and 448 noted the importance of scale to the viability of supermarkets. That remains the case. Foodstuffs, Woolworths, suppliers and The Warehouse itself, all advised the Commission that scale is an important factor in respect of the purchase of groceries. To some extent scale relates to the size of the store but, more significantly, it comes from having multiple stores on a national basis. A new entrant would not be able to achieve the scale efficiencies available to the incumbents until it achieved a similar scale of operation.

Economies of Scope

238. As noted above, The Warehouse is seeking to offset its scale disadvantage compared with the incumbent supermarkets by accessing economies of scope. Scope economies may be achieved by spreading fixed costs over more than one activity. In the case of supercentres the activities are the retailing of general merchandise and the retailing of groceries.
239. The Commission considers that only The Warehouse (or an independent owner of The Warehouse) has the potential to achieve sufficient scope economies to be able to offset scale disadvantages in the supermarket markets.

Likelihood of Entry

240. The height of the entry barriers suggest that new entry is not at all likely. However, both applicants have suggested that Aldi is a potential entrant.
241. Aldi is an international grocery retailer with a network of more than 5,000 stores throughout Europe, the USA and Australia. Aldi entered Australia in January 2001, and now operates 140 stores in Victoria, Queensland, ACT and New South Wales.⁵² Aldi operates discount stores that are relatively small in comparison to traditional supermarkets (with around [] SKUs compared with 8,000 to 20,000 carried by supermarkets).
242. Coriolis Research⁵³ advised the Commission that, apart from supercentres, the only other area of growth in the supermarket industry internationally has been from discount stores, such as Aldi.

⁵² As at March 2007.

⁵³ Tim Morris, Managing Director, Coriolis Research, at an interview with Commission staff on 13 April

243. Woolworths considered that Aldi, with its international presence, would be able to compete extremely effectively with both Foodstuffs and Woolworths, despite its initially smaller New Zealand scale.
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244. Aldi advised the Commission that it registered a number of trademarks in New Zealand at the time it entered into Australia. It has informed the Commission that its recent renewal of the trademarks [].
245. [
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246. Aldi told the Commission that its global strategy is
[]. However,
[
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247. Aldi advised the Commission that, with its limited number of SKUs and smaller stores, it caters for a different niche in the marketplace than supermarkets. Its business model is quite different from that of the incumbent supermarket operators in both Australia and New Zealand. Aldi stated that, in Australia,
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248. Michael Kloeters, Group Managing Director, Aldi Australia, advised the Commission that,
[
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249. The Commission has placed little weight on Aldi being an effective competitor to New Zealand supermarkets in the future.
[
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250. The Commission has considered whether any party, other than the applicants and The Warehouse, has the potential to develop the supercentre concept in the way being attempted by The Warehouse. It has concluded that there are none.

Fringe Competitors - Specialist Retailers

251. As noted in the market definition section above, there are a number of other retail outlets that offer goods that are also sold in supermarkets. These include:
- Star Mart, a chain of convenience stores and other service station convenience stores (eg “BP Select”, “Mobil on the run”, etc);
 - specialist chains such as the Mad Butcher and Bakers Delight;

- Asian and other stores catering for ethnic food and other requirements;
 - fresh fruit and vegetable outlets, and
 - dairies, liquor stores, etc.
252. For the reasons provided in the market definition section above, these retailers do not offer the “one stop” convenience and other attributes of the main supermarkets, to be included in the market supermarkets operate in. The Commission acknowledges, as it did in Decision 438, the presence of specialist retailers and the tendency for them to be used for “top up” shopping. While in total, a lot of money is spent by consumers at these outlets annually, their constraint on supermarkets is however quite limited.
253. The proposed acquisitions will not affect the level of such constraints from these retailers in the relevant supermarket markets. Their presence has been taken into account in the analysis in the following sections.

Competition in the Factual and the Counterfactual

254. The current level of competition in the relevant markets can be a helpful guide to the assessment of future competition. However, the Commission emphasises that it is a forward-looking analysis that is required.
255. Assessing the competitive changes arising from the acquisition requires an assessment of the level of competition in the factual (i.e. with the acquisition) and in the counterfactual (i.e. without the acquisition). Accordingly, in this section below the Commission has assessed sequentially:
- competition in the counterfactual; and
 - competition in the factual.
256. Once existing, potential and other competition factors have all been considered in terms of the factual and counterfactual scenarios, the Commission can then make an assessment as to whether either of the proposed acquisitions would result, or be likely to result, in a substantial lessening of competition in the relevant market or markets. A substantial lessening of competition is equivalent to the ‘creation, enhancement or facilitation of the exercise of market power’ in those markets. It is the creation of the potential for a business to exercise market power that is the focus of the analysis, rather than whether or not the market power would actually be exercised should it be obtained.

Competition in the Counterfactual

257. The section below considers the experience overseas of supercentres, where they have been established for some time, and the competitive impact of the Warehouse Extra stores in New Zealand to date. The section also considers the particular impact a vigorous and innovative firm may have on competition in the markets.

The Overseas Experience with Supercentres

258. The Commission has reviewed literature on the entry of supercentres in overseas markets. In the main that literature suggests that supermarkets in the vicinity of a hypermarket regard that hypermarket as a strong competitive force, and that a new hypermarket typically results in supermarkets reducing prices significantly or adjusting the service that they offer consumers. The

Commission put these views to the applicants as an indication of what might happen in New Zealand.

259. Woolworths submitted that there are important contextual differences in the New Zealand and Australian supermarket industries that would make the supercentre model less influential than in other countries. These differences include:
- shopping centres and shopping malls are already well established, unlike in Europe at the time of supercentre entry;
 - there are existing supermarket operators in New Zealand who have considerable scale and hold the lowest price space in the market place;
 - the different banner groups of both Foodstuffs and Woolworths provide variations in the degree of range of products they offer; and
 - the incumbent operators are the innovators in the market place through initiatives such as the fuel discount scheme.
260. CRA, for Foodstuffs, submitted that the response of supermarkets to supercentres is a contentious issue.⁵⁴ It notes the conclusions of Hausman and Leibtag⁵⁵ and others, which suggest that supermarkets must reduce their own prices to stay competitive with supercentres. However, it also notes that a growing body of research has found no statistical evidence to suggest that supercentres induce rivalry among competitors leading to lower prices. It suggests that greater differentiation of stores may mean there is less need to compete on price.
261. While recognising that each country is different, the Commission considers that overseas evidence is supportive of the view that supercentres generally have a strong competitive influence in the supermarket markets. This competition has a number of components, with the most important being, usually, price and service. In some countries, such as the United States, supercentres (including Wal-Mart's supercenters) typically sell groceries at very low prices, while in other countries it seems to be the range of product available in the store which is the principal attraction for customers who would otherwise buy their groceries in traditional supermarkets.

New Zealand Experience to Date

262. Foodstuffs and Woolworths each submitted that the entry of The Warehouse Extra format has had no impact on their pricing behaviour, either in the Sylvia Park or the Whangarei regions, or in the regions that Foodstuffs and Woolworths have separately identified as those where The Warehouse could potentially convert an existing Warehouse store (such as Te Rapa).
263. Both of the applicants have claimed to the Commission that they do not consider that Extra stores pose a competitive threat to them. However, in the summary of the Woolworths' report
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⁵⁴ Memorandum from CRA International dated 16 April 2007, provided to the Commission with letter from DLA Phillips Fox dated 23 April 2007.

⁵⁵ Jerry Hausman and Ephraim Leibtag, "Consumer Benefits from Increased Competition in Shopping Outlets: Measuring the Effect of Wal-Mart", MIT and Economic Research Service, 2005, US Department of Agriculture, Revised Draft.

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264. That report also included the following statement:

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265. When asked about these comments, Woolworths said that they were made before The Warehouse had opened any of its Extra stores. It said that the actual opening of the Extras at Sylvia Park and in Whangarei did not cause it to lower prices.

266. In respect of Foodstuffs' reaction to The Warehouse as a competitor in the supermarket markets,

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267. In the Commission's view, these comments clearly illustrate that Foodstuffs considers The Warehouse as a realistic competitive threat to at least some of its stores.

268. It is useful to review the initial pricing strategies employed by the supermarkets at the new stores in Sylvia Park. At the time the Sylvia Park Extra was opened, Woolworths opened a Foodtown supermarket in the same shopping complex. Foodtown is Woolworths' full service banner, but at Sylvia Park Woolworths decided to charge []. Elsewhere, the prices in Foodtown stores are typically [] than in Countdown stores.

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⁵⁷ [.]

269. Shortly after the opening of the Warehouse Extra and Foodtown at Sylvia Park, Foodstuffs opened a Pak'n Save supermarket in the same shopping centre. Initially, [].

[].

270. Both Foodstuffs and Woolworths claimed to the Commission that their competitive behaviour at Sylvia Park was largely in response to the presence of each other, rather than to the existence of the Warehouse Extra store.

271. In Whangarei, Woolworths advised the Commission that [].

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272. Having regard to all of the above, the Commission considers that the Warehouse Extra stores already have had an important competitive influence on supermarkets. This has been particularly so in the period leading up to the opening of the first store.

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The Importance of a Maverick to Competition

273. Sometimes a market contains a firm that is in some way non-typical, or has different characteristics, or is an innovator, or is a maverick. As the Commission notes in its *Merger and Acquisition Guidelines*, the independent or less predictable behaviour of such a firm may be an important source of competition in the market. Such a business need not be large to have an impact on competition out of proportion to its relative market size.

The Warehouse as a 'Maverick'

274. In May 2007, The Warehouse celebrated 25 years of operations. It now has an important and well-established presence in New Zealand retailing with its familiar Red Shed format. In its early days it introduced a level of discount retailing and every day low prices well beyond that seen previously. The Commission sees it as an important New Zealand leader and innovator in retailing, specifically in such things as developing new supply lines, taking advantage of parallel importing opportunities, reporting on its environmental and social performance, developing staff relations, and so on.

275. However, like many entrepreneurial firms, not all of its innovations have been successful. Its attempt to enter Australian markets was costly and ultimately unsuccessful.

276. The Warehouse's move to introduce supercentres is the latest of its innovations. The Commission regards supercentres as 'atypical' supermarkets. They differ from supermarkets in that they operate on a different business model, with

different costs and different incentives. A principal aim of the grocery part of the supercentre is to attract additional consumers to the higher-margin general merchandise. Thus, supercentres may have an incentive to sell groceries at low margins, or to provide a different service to that found in supermarkets, if by doing so it would attract additional customers into the store and those customers also buy general merchandise items. Supercentres may choose to treat the grocery side as incremental to the general merchandise side, and set prices accordingly.

277. Woolworths submitted that The Warehouse, in respect of groceries and the Extra concept, has merely copied low value overseas models. For example, Woolworths considered that :
- the Extra stores do not show price leadership; and
 - the Extra stores do not offer a convenience that is not already provided by shopping centres and precincts.
278. The Commission recognises that The Warehouse has been influenced by the success of Wal-Mart and others overseas when introducing supercentres. Nevertheless, in respect of New Zealand, the development is undoubtedly innovative. Further, as discussed, the Commission considers that having the lowest priced goods need not be critical to best meeting consumers' requirements, and that a range of shops within the one shopping centre may not provide the equivalent service to a supercentre in consumers' eyes.
279. The Commission considers that The Warehouse is a dynamic and innovative company. It has brought to the supermarket market a new concept, the supercentre, which has different costs and cost drivers to those associated with traditional supermarkets. In the Commission's view it qualifies as a 'maverick', and as a potentially vigorous and effective competitor, while it remains independently owned. As grocery buyers switch to the new concept, existing supermarkets will be forced into competitive responses by, for example, lowering their prices, offering more specials and improving levels of service.

The Potential for Others to be a Maverick in the Markets

280. The Commission considers it unlikely in the foreseeable future that other firms would be in a position to enter the supermarket market (either as a stand-alone supermarket operator or as a supercentre operator) and play a "maverick" role. The applicants have suggested Aldi as a potential entrant, but as discussed earlier, the Commission has given little weight to this possibility
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Conclusion on Competition in the Counterfactual

281. The Commission concludes that both international experience of supercentres, and the experience of the limited time they have been operating in New Zealand are strong indicators that an independent The Warehouse will provide very important competition in the supermarket markets. This will arise, in part, as a result of the innovative approach The Warehouse supercentre concept brings to the market.

282. This prospective level of competition has now to be compared with that likely in the factual, where the Warehouse and its Extra stores would disappear as an independent competitive force in the supermarket markets.

Competition in the Factual

Competition between Foodstuffs and Woolworths

283. In each of the relevant local markets there are both Foodstuffs and Woolworths supermarkets under some or all of their respective banners. On average over these markets Foodstuffs has an aggregated 56% share and Woolworths 44%. In its application Woolworths stated that the retail markets are already very competitive. It said:
- Competition between Foodstuffs and Woolworths in the retail food, liquor and grocery market is intense as evidenced by the competitive activity described in [], the fact that average real food, liquor and grocery prices have generally fallen since the 2002 Acquisition and the fact that there have been no material changes in gross margins since 2002. The Acquisition will not reduce the intensity of competition between Woolworths and Foodstuffs.
284. The competitive activity referred to by Woolworths also included fuel discounts, loyalty programmes, broadened product offerings, self check-out pilot by Foodstuffs South Island, Woolworths/Foodtown online shopping site, ongoing drive to improve speed to market, and food, liquor and grocery magazine innovation.
285. In its application Foodstuffs also stated that in markets where there are no The Warehouse Extra stores, it currently competes vigorously against Woolworths.
286. The Commission accepts that Woolworths and Foodstuffs compete against each other. The issue which the Commission must address however, is the extent to which the level of competition changes as a result of the loss of The Warehouse as an independent competitive force.

Foreclosure of New Entry

287. As discussed above, the Commission considers that there are significant barriers to entry into the supermarket markets. It further considers that The Warehouse is in a position to overcome these barriers because, amongst other things, it is a well-known brand, has a well-developed distribution infrastructure and, perhaps most significantly, a “bank” of properties and sites in locations throughout New Zealand that are suitable for supermarket retailing, and with appropriate resource consents. Indeed, it has entered, or is about to enter, three local markets, with more in prospect.
288. The Warehouse has chosen to enter the supermarket markets by way of the supercentre concept. That concept is still being tested and its success is not guaranteed. The Commission recognises that if the concept were not to prove viable within a reasonable timeframe, the existing owners and managers of The Warehouse might choose to withdraw from it. However, while The Warehouse remains independently-owned the opportunity remains for them, or their successors, to develop their skills and adapt the model to make the supercentre concept work.
289. On the other hand, if either acquisition were to proceed, the potential for The Warehouse to be used as a vehicle to provide competition to the two existing

supermarket firms would be foreclosed. The Commission considers that there are no other firms able to provide a similar vehicle. Consequently, either acquisition would be likely to effectively exclude the potential for entry into the supermarket markets for the foreseeable future.

Non-coordinated and Coordinated Effects

Introduction

290. Acquisitions in markets that are or will result in tight oligopoly structures may lessen competition in two main ways:
- by removing competition constraints that lead to an increase in market power of the remaining firms (non-coordinated effects); and/or
 - by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).
291. Such behaviour would require that potential entry is unlikely, for otherwise attempts to exert market power would be undermined by the entry of new competitors. A lessening of competition under either limb is more likely, and likely to be serious, where the acquisition results in the elimination of an innovative firm.
292. In general, non-coordinated or coordinated effects that lessen competition may lead to innovation, quality and service being lower than they would be otherwise, as well as prices being higher than they would be otherwise.
293. The Commission has assessed both the non-coordinated and coordinated effects arising from the differences between the factual and the counterfactual. Although these concepts are distinct, it is often difficult in practice to distinguish the effects of one from the other.

Factors Relevant to both Non-coordinated and Coordinated Effects

294. The competition factors discussed in the previous sections are relevant to the consideration of whether the proposed mergers will increase the likelihood of non-coordinated or coordinated effects. In summary, they are:
- High Market Concentration: until The Warehouse entered the market with its Extra supercentres, Foodstuffs and Woolworths were fairly evenly-matched competitors sharing the markets in all regions between themselves. The proposed acquisitions would result in a return to this situation, by reducing an already very limited choice of supermarket groups from three to two in those regions where Extras have been established, and in those regions where The Warehouse is planning to roll them out, notably Te Rapa.
 - High Entry Barriers/ Loss of Potential Competition: entry barriers are already high due to the difficulty in accessing suitable sites, obtaining resource consents and the presence of economies of scale. Apart from The Warehouse, there has been no de novo entry in this market for over 20 years, and the possibility of any new entry (let alone speedy new entry) by others is remote. The proposed acquisitions would eliminate an important source of competition for the incumbent supermarkets in those regions where it is planned to roll out Extra supercentres over the next[]. Furthermore, the acquisitions would remove the possibility of The

Warehouse's existing sites and resource consents being acquired by another independent operator to enter the supermarket retailing market.

- Loss of a Maverick: The Warehouse is a recent innovative entrant that can be characterised as a maverick. The supercentre business model differs from that of the incumbent supermarket groups, and it is motivated to significantly increase sales to make the concept successful. The proposed acquisitions would eliminate this maverick and the innovation it has brought, and there are unlikely to be any others that would be able to take on this role.
- Lack of Fringe Competitors: the competitive constraint provided by fringe players, such as speciality and convenience stores, is weak. Supermarkets, when setting prices, typically pay much less attention to the prices being charged by specialty and convenience stores than they do to competing supermarkets, and a large percentage of consumers appear not to regard them as viable alternatives for their main grocery shopping requirements.
- Product Differentiation: while supermarkets can be differentiated in several ways - for example, by location (spatially), by the combined price and quality of the service, or by convenience through breadth of offer - they may not be sufficiently differentiated to prevent coordination on prices. For example, a number of the products stocked by supermarkets are similar, if not identical.
- Price Inelasticity of Demand: as noted in Decision 448, while the demand on a product-by-product basis is likely to vary considerably due to varying levels of "necessity" across products, the demand for the retailing of grocery items, taken together, is very likely to be price inelastic. As a result coordinated and non-coordinated price increases in the factual are likely to be profitable.
- Low Technological Changes: the production technology in supermarket retailing is relatively static. To the extent that new technological developments impact on supermarkets, they appear to have been imported and are available to both firms reasonably simultaneously.

Non-coordinated Effects

295. When the products of firms are differentiated, buyers do not regard them as perfect substitutes. The substitutability (or "closeness") between products can be influenced by many characteristics: physical nature, brand image, customer service and geographical location of sale. Consumers have differing tastes or preferences. Some pairs may be closer substitutes than others in the eyes of different groups of consumers.
296. Consider a market with a number of differentiated brands, A, B, C, D, etc. Pre-merger, prices for each brand may be above marginal cost because each may possess some degree of market power, based on product differentiation. But Firm B, for example, may not be able to raise its price further because it would not be profitable to do so, given the prices of the other brands: customers would generally buy less of B, or cease buying it altogether, and buy more of adjacent brands A and C.
297. Suppose brands B and C were to merge. Post-merger the competitive situation would change. An increase in B's price may now be profitable for the merged

firm, if some of the customers lost to brand B were to switch their demand to brand C. Such customers would no longer be lost, but rather would be “recaptured” within the merged firm. In other words, the merger would remove brand C as a constraint on B’s pricing. In addition, an increase in A and D’s price may also now be profitable because the merger has removed the competitive constraint of an additional firm in the market.

298. The Commission considers that in supermarkets markets, competitors’ offerings are differentiated. The Commission considers that in the factual both the merged firm and the other supermarket would have less incentive to compete vigorously with each other due to the loss of the competitive constraint of The Warehouse. These effects are likely to materialise not only in the regions where The Warehouse has already rolled out or plans to roll out its Extra stores (Whangarei, Mt Wellington and Te Rapa local markets), but also in those locations where the greatest potential exists for The Warehouse to roll out the supercentre concept over the next []. In contrast, in the counterfactual, the presence of an independent innovative maverick like The Warehouse is likely to provide an effective competitive constraint on both Woolworths and Foodstuffs in these regions.
299. In Decision 448, the Commission also investigated whether non-coordinated effects resulted from the three to two reduction of supermarket groups utilising economic modelling to assess future price increases. The results were found to be ambiguous, and no firm finding was made. There are quite different circumstances in relation to the present applications, as we are dealing with the new supercentre concept, and the effect it might have in the future, rather than with a third conventional supermarket operator.
300. As noted above, The Warehouse is a recent innovative entrant that can be characterised as a maverick. The supercentre business model differs from that of the incumbent supermarket groups, and it is motivated to significantly increase sales to make the concept successful. The proposed acquisitions would eliminate this maverick, and there are unlikely to be any others that would be able to take on this role.
301. The Commission considers that in the factual the loss of an innovative competitor would also remove dynamic competitive pressure on Woolworths and Foodstuffs over time to improve their offerings by reducing prices, improving service and quality or being more innovative. In contrast, in the counterfactual, the presence of an innovative competitor is likely to spur The Warehouse, Woolworths and Foodstuffs to compete more vigorously with each other to further deliver lower prices, better quality, improved levels of service, and innovative new products and services to consumers.

Coordinated Effects

302. In concentrated markets where competitors regularly interact and other factors are present, competition may be lessened as a result of coordinated effects. In this case, this could come about through Foodstuffs and Woolworths either each individually coming to a mutually profitable expectation as to coordination (tacit collusion), or together reaching an agreement over coordination (explicit collusion).
303. In Decision 448, the Commission concluded that the factors that facilitate collusion were present in the supermarket markets, and that the merger that

would reduce the number of players in these markets from three to two would be likely to materially enhance the potential for collusion. Factors relating to the facilitation of coordination have already been identified above. Many of those factors relied on by the Commission in the previous Decision remain in existence.

304. What is important is whether coordination is more likely, effective and stable in the factual than in the counterfactual. The Commission considers this to be case. In particular:

- the proposed acquisitions would restore a duopoly of two evenly-matched competitors that would make coordination easier;
- Woolworths and Foodstuffs sell many similar grocery lines on which they could coordinate prices;
- with the elimination of The Warehouse, there are unlikely to be any factors that would destabilise coordination such as another maverick firm, or a competitive fringe; and
- demand is likely to be price-inelastic, which enhances the scope for profitable price rises.

305. The focus of the risk of coordination in merger cases is often in terms of pricing. However, as the Commission has recognised in other Decisions, there are many dimensions of competition in addition to prices on which firms may coordinate.

306. Foodstuffs and Woolworths set or suggest retail prices, run promotions and make other decision's affecting their supermarkets from their respective head offices. Retail prices are monitored regionally, and can differ between regions to take into account local conditions, as well as between banner groups.

307. The Warehouse Extras will affect competition initially in a comparatively small number of regions. The Commission accepts that in those regions where there is no prospect of entry by The Warehouse supercentres being established, the acquisitions will not likely facilitate an increased likelihood of coordination, when compared to the counterfactual. However, the presence or likely entry of these supercentres in the relevant supermarket markets will lower the risk of coordination in those markets.

[

], is evidence of the ability and means to deal with market issues at local levels, and the potential de-stabilising effect these supercentres can have.

308. For coordination to be successful, Woolworths and Foodstuffs also need to be able to detect swiftly any deviation from the likely coordination, and have a credible means of retaliation.

Ability of Each Firm to Identify and Respond to Deviation

309. Factors that affect the ability of firms to identify a deviation include high seller concentration, the frequency and size of individual sales, the extent and nature of any vertical integration, the stability of market shares and growth, the similarity of cost structures and the transparency of prices. Factors that affect the ability of firms to retaliate to a deviation include the credibility of threats from non-deviating firms, the availability of excess capacity, a strong profit incentive to preserve collusion and the ability to disadvantage a deviating firm.

These factors were fully considered in Decision 448 (paragraphs 190 – 221). The Commission concluded then that it was satisfied that the ability of each firm to identify and to respond to deviations from co-ordinated behaviour would be present following the Progressive/Woolworths NZ merger.

310. The Commission has reviewed these factors and considers that there has been no material change in these factors since that Decision. It therefore remains of the view that they apply to the supermarkets markets today. In particular, it notes that Woolworths and Foodstuffs constantly monitor each other's prices. Thus, detection of deviations would be relatively straightforward. The Commission observed in paragraph 223 in Decision 448 that a "leader-follower" form of tacit collusion could arise from this structure.

311. In terms of retaliation, the simplest form can consist of a breakdown of the coordination and a return to "normal" competition and profits. The US Horizontal Merger Guidelines state:⁵⁸

Deviation from the terms of coordination will be deterred where the threat of punishment is credible. Credible punishment, however, may not need to be any more complex than temporary abandonment of the terms of coordination by other firms in the market.

312. A return to "normal" conditions may be sufficient on its own, but the possibility of a price war could also be very damaging.

Submissions on Co-ordination by the Applicants

313. In its submission to the Commission dated 18 May 2007, DLA Phillips Fox for Foodstuffs, stated:

We agree that higher seller concentration with high barriers may facilitate coordinated behaviour.

However, high seller concentration and barriers to entry apply under current market conditions. Further, tacit collusion does not occur under current highly competitive market conditions between Foodstuffs and Woolworths.

Foodstuffs believes that acquiring The Warehouse will not change these factors. Accordingly, the proposal does not materially enhance the prospects for co-ordinated market power between Foodstuffs and Woolworths ...

314. Woolworths submitted that there is no evidence that there is tacit collusion between the supermarkets currently, nor is there any evidence that tacit collusion is likely to occur in the future. It added:

There is no evidence that tacit collusion has been or is currently occurring, as evidenced by:

- [];
- [];
- A decline in real grocery prices as evidenced by Progressive's published inflation rate of 1.7% compared to general inflation running at around 3%, and general catalogue price reductions;
- [];
- [];

⁵⁸ US Horizontal Merger Guidelines at paragraph 2.12.

- [];
- Progressive and Foodstuffs constantly checking each other's prices. Woolworths considers leading advertised prices have fallen to levels not seen in the last 10 years;
- Continuing strong service competition and innovation; and
- []

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315. Woolworths provided reports prepared by Frontier that argued that there was no evidence of coordination flowing through to price rises since the 2002 merger (these are discussed in more detail below). However, what is more important to the Commission is whether the removal of the constraints provided by The Warehouse would make the environment easier for the incumbent supermarket chains to conduct and maintain coordination looking into the future.
316. Relevant to the issue of current and future coordination is information received that provides an insight into current pricing practices.

Information from Current Pricing Practices

317. The Commission has obtained from Woolworths an internal report by Progressive dated 2 June 2006
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318. The Commission questioned Woolworths as to whether this extract
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Bell Gully, for Woolworths, subsequently responded as follows:⁵⁹

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⁵⁹ Letter from Bell Gully to Commerce Commission, dated 23 April 2007.

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319. The Commission acknowledges the points made by Woolworths in its response. Nevertheless, it notes that a

[

], would not usually be found where there is effective competition.

Nor would it be likely in a competitive market for a firm with something around 44% share of the markets

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] market conditions are conducive to conscious parallelism, price leadership and coordinated behaviour in general.

Woolworth's Assessment of the Impact of the 2002 Merger

320. Woolworths has suggested that a merger that reduces the number of market participants from three to two does not necessarily substantially lessen competition. In support of this proposition, Woolworths provided reports prepared for it by Frontier Economics (Frontier), including a report entitled "Ex post evaluation of Commerce Commission Decision 448,"⁶⁰ about the impact of the 2002 merger between Progressive and Woolworths NZ.

321. In brief, Frontier generated product prices for 200 best-selling products for all banners in the Woolworths' group, and for the Foodstuffs group as a whole. The data covered the period January 2000 to October 2006, and was provided to Frontier by Woolworths. Each price was tested for significant movement around the time of the 2002 merger. It attempted to determine whether the price for any of the best-selling 200 products in any banner group changed because of the merger.

⁶⁰ Frontier Economics, "Ex post evaluation of Commerce Commission Decision 448, 23 January 2007", para 61- 66

322. Frontier's study concluded as follows:

None of the empirical evidence suggests that there have been adverse effects arising from the Progressive and Woolworths merger in 2002. There have been price increases for individual products due to inflation, but we did not find an increase in prices before and after the merger. Instead, we found an average price decrease across the range of products that we tested as a result of the merger.

The implicit collusion tests are more difficult to interpret; the results are consistent with a leader follower model, with both Woolworths and PEL prices following Foodstuffs prices, especially in the period before the merger. However it is difficult to determine whether this indicates coordination, or competition with the less dominant group following the lead of the dominant group.

Indeed we found that after the merger, the intensity of price following decreased suggesting that the efficiencies resulting from the merger promoted competition. The result is consistent with the structural change analysis finding that prices seemed to have decreased in the period following the merger.

The structural change analysis gives a straightforward result: the merger between Progressive and Woolworths did not lead to an increase in prices. The merger seems to have been one of those identified by the Commission where the "reduction in market participants may lead to an enhancement of competition (particularly if efficiency gains are realised)."⁶¹

The empirical analysis has an important lesson for any potential merger between Woolworths and The Warehouse Group. That merger may be thought to give rise to a possible lessening of competition because The Warehouse Group is a small but potentially expanding competitor supermarket for Progressive and the Foodstuffs Group. Although the increase in concentration caused by such a merger is difficult to predict (it depends on the success of The Warehouse in developing its hypermarkets), similar arguments may be raised.

The retail data suggests that the Commission's concerns of 2001-02 did not eventuate in practice. The lessons from the analysis also suggest that any merger between Progressive and Warehouse would be unlikely to result in a lessening of competition.

323. On 1 June 2007 Woolworths provided the Commission with a further report prepared by Frontier,⁶² which commented on what inferences could be drawn from regional pricing and banner data provided to the Commission by Woolworths. The Commission had asked for the data from the five localities because these were those local markets most likely to show any effects from the 2002 merger. For each region, Frontier regressed the price for each SKU on a constant trend and included a dummy variable to capture any effects of the 2002 merger. It also included a time trend to account for any increases in prices over the course of the entire period. Frontier also compared the regional series to a national benchmark. Frontier concluded that its work on regional data did not indicate the presence of collusion in the nominated regions, and that there were no systematic structural changes in prices due to the merger.

324. Frontier also concluded in this report that two factors supported the view that Woolworths' acquisition of The Warehouse would be highly unlikely to substantially lessen competition. These factors were:

- The Warehouse Extra stores are unlikely to present a strong challenge to the banner group of the two major chains; and

⁶¹ Decision 448, para 154.

⁶² Frontier Economics, "Local Effects on competition of proposed acquisition of The Warehouse Group by Woolworths", 1 June 2006.

- the national retail grocery market does not exhibit the characteristics that one would normally associate with tacit collusion.
325. The Commission is unable to accept either view based on other material before it, either as a matter of fact or analysis. It considers that The Warehouse Extra is capable of providing strong competition to the incumbent supermarkets in the future. Also, it considers that the relevant retail markets are local markets and, as discussed above, that they have characteristics that would support coordinated and/or non-coordinated behaviour.
326. The Commission has given careful consideration to the other points made in the Frontier analyses. There are a number of general points that it considers are relevant:
- The Commission accepts that a merger that reduces the number of firms in a market from three to two does not necessarily substantially lessen competition. The competitive effects need to be assessed on a case by case basis, taking into account such matters as the height of entry barriers. In this case the Commission considers that, for supermarket markets, the entry barriers are very high. In general, the Commission considers that in most circumstances, as a matter of usual economic analysis, that a three to two scenario reduces competition, but the normal presumption is rebuttable (as it largely depends on the overall market structure and in particular the likelihood and extent of entry), and the lessening of competition may or may not be substantial.
 - The 23 January 2007 Frontier report notes that the results of its implicit collusion tests are consistent with a leader follower model. This suggests that the Commission's normal presumption that the three to two merger would lead to coordinated effects is appropriate.
 - The Frontier analysis seeks to draw conclusions from a merger which took place in 2002 and to apply those conclusions to the current case. The Commission accepts that the 2002 merger involved the supermarket markets and was a three into two situation. To that extent, it had some similarities with the current case. But, there are also very significant differences. For instance, in 2002 the merging parties were well-established, but both claimed they were having difficulty competing effectively against the larger Foodstuffs' operation. The current case would involve the removal of a maverick new entrant that is seeking to introduce a new concept to supermarket shoppers using a new business model. The Commission considers that the potential effects of the mergers currently proposed and the 2002 merger are likely to play out quite differently. The Commission is of the view that the potential for loss of competition is greater in the present case.
 - The Frontier report emphasises that it has found that prices have decreased over a range of products since the 2002 merger. Even if prices have reduced (such as from lower prices from suppliers), this does not, in itself, indicate that competition has not reduced as a result of the merger. Prices might well have fallen further in a more competitive market. For example, the UK Competition Commission is undertaking a major study into the state of competition in grocery markets to determine whether any features of the markets distorts competition, even though it has noted in its Emerging

Issues paper that the real price of food has declined by around 7% since 2000⁶³.

327. The Commission has significant reservations about particular features of the approach adopted by Frontier. Its approach is based on national average prices, implying that the relevant supermarket market is a national one, whereas the Commission is of the view, in both this Decision and in two previous ones, that the markets are local in nature. Moreover, the Frontier methodology, even in the June report, does not adjust for a range of factors that would be expected to influence prices at both the national, and more importantly, at the local level. These include: the increasing proportion of supermarkets operating under banners at the low price/low service end of the spectrum; the number and mix of banner types in particular local markets and the local competition between them; and likely seasonal variations in prices. As a consequence, Frontier attributes to the merger the great bulk of price changes without controlling for any of the major factors that can be expected to influence prices on both a national and local level.
328. Given the limitations with the Frontier approach, the Commission sought data from both of the applicants relating to five local markets most likely to be affected by the 2002 merger (Frontier had access only to the Woolworths' data). The Commission sought to analyse the data by modelling how prices would have been expected to unfold post-merger based on relationships between variables established in the pre-merger period, and to compare these prices with those actually observed post-merger, in order to determine whether any sound conclusions could be reached as to the impact of the 2002 merger.
329. In carrying out its analysis, the Commission found that the data provided had significant apparent limitations: there was no data at all for some of the Foodstuffs and Woolworths stores, and the data indicated a very substantial, step change in Progressive's prices in early 2004, for which there was no likely explanation other than data error. It is possible that two incompatible data sets were spliced together, which, if that were the case, would call into question the validity of all of the data and any analysis based on that data. At the very least the Commission considers the data could not be relied upon. As part of the Woolworths-related data was used by Frontier, it called into question the reliability of the Frontier analysis.
330. The Commission endeavoured to test the Frontier's conclusions on local market effects through its own analysis of the data set. It first accepted the data as being accurate, and then sought to control for the effect of the data's sudden and inexplicable step change in price in early 2004 by econometric means. The results of this analysis suggested that contrary to the results found by Frontier, there may have been possible increases in prices charged by the Progressive stores of some 2-3% when not controlling for the 2004 step change; and, potentially price increases as much as 12-13% when controlling for the 2004 step change. The difference in these results meant that the Commission could not accept them as reliable. Overall the analysis tended to point to a scenario consistent with what could be expected: that the more discount stores in a local market the lower the prices in that market. As far as it could be taken, the

⁶³ Competition Commission, Groceries Market Investigation, Emerging thinking report, para 9, 23 January 2007.

analysis did not support the propositions advocated by Frontier, but rather pointed to a contrary position.

331. Overall, the Commission's results tended to support the qualitative assessments it had already arrived at, and did not support the conclusions reached by Frontier. The striking difference between the two sets of results illustrates how different model specifications can lead to different outcomes. However, the Commission could not have confidence in either set of results given the inexplicable issues with the data.
332. The Commission was left with a position where, because of the data problems, there were no reliable econometric results. Any further analysis would need to be more extensive, and even then could only be used as a guide to assist the analysis of relevant factors. A full econometric modelling exercise would have required significant data, data verification and subsequent analysis with little gain likely in the circumstances, particularly given the other material before the Commission.
333. The Commission, in reaching its Decisions on the applications, therefore considers that it is unable to place any weight either on the pricing analysis by Frontier and the inferences drawn, or on the Commission's own pricing analysis.

Conclusions on the Competitive Impact of the Acquisitions in the Supermarket Markets

334. The Commission has therefore concluded that the loss of existing and potential competition from an innovative firm in circumstances where it is the only likely entrant for the foreseeable future, and the other resulting foreclosure effects for other possible acquirers in the future, would lead to a substantial increase in market power of the remaining incumbent supermarkets. As a result of the loss of this significant competitive constraint in the factual, there is a real risk that prices would be materially higher, and quality, service and innovation materially lower, than in the counterfactual through either or both non-coordinated or coordinated effects. A lessening of competition through non-coordinated effects would materialise through a reduction in the incentive for both Woolworths and Foodstuffs to compete vigorously because of the loss of an innovative competitor. A lessening of competition through coordinated effects will materialise through the increased ability and incentive of Woolworths and Foodstuffs to coordinate their behaviour on prices and possibly on other dimensions of competition.
335. Having reached these conclusions, the Commission cannot be satisfied that the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant supermarket markets.

THE NATIONAL MARKET FOR THE WHOLESALE SUPPLY OF GROCERIES

Introduction

336. Both Woolworths and Foodstuffs are major buyers in the market for the wholesale supply of groceries. The suppliers are the grocery manufacturers, of which there are many, both large and small, most tending to specialise in limited ranges of goods. Apart from the two supermarket operators, other buyers

include independent dairies, petrol stations and other members of the “route trade”, although many of these are supplied by Foodstuffs wholesaling operations. The Warehouse has entered this market as a buyer, by virtue both of its selling of a limited range of dry goods through its conventional stores, and more recently by offering a wider range of groceries through its Extra stores.

337. In its application, Foodstuffs submitted that the wholesale market was not relevant to the merger proposal “as The Warehouse does not compete as a seller in the Wholesale Market”. However, this overlooks the buyer side of the market. The question is whether, by eliminating The Warehouse as an independent buyer of groceries, the proposed mergers may have an impact on competition in the market for the wholesale supply of groceries through increasing the buyer power of the supermarkets chains in relation to their suppliers. It is also possible that this buyer power for groceries could have an impact in downstream retailing markets.

Buyer Market Power

338. The extent to which a grocery retailer will have buyer power depends on the nature of its relationship with its suppliers. Grocery retailers’ relationships with their suppliers can be characterised in two broad ways: first, those situations where there are numerous suppliers and a single ‘market price’ is paid by all grocery retailers to their suppliers for the product in question (a market framework); and second, those situations where suppliers are relatively concentrated and prices and other terms are negotiated bilaterally (a bargaining framework).
339. In a market framework the main factor that determines the extent of a grocery retailer’s buyer power is the proportion of a particular product’s total sales accounted for by that grocery retailer. In a bargaining framework, the reliance of a grocery retailer on its supplier is the main factor that determines the extent of its buyer power. The reliance of a retailer on a supplier will, in turn, be affected by factors such as the size of the grocery retailer relative to its supplier, the absolute size of the grocery retailer and its supplier, and the supply of housebrand products that compete with the supplier’s products.
340. In a market framework if suppliers’ production costs increase with the volume produced, generating an upward-sloping supply curve, large buyers might withhold demand to reduce the purchase price and generate a better margin on the sale of these products. In buying more the buyer drives up the price for additional units of goods as well as for all infra-marginal units, so the marginal cost of an extra unit exceeds the price (it is the sum of the price of this next unit plus the increment to the price for all other units purchased). This results in the marginal cost curve lying above the supply curve. As a consequence, the single buyer, by maximising profits by equating demand with marginal cost, in contrast to the competitive outcome where demand equals supply, buys fewer units and pays a lower price for them (as determined by the supply curve). This causes a loss of allocative efficiency, but no particular harm to the suppliers in aggregate, since they are still operating at a point on their supply curve.
341. This result follows from the assumption in the model of an upward sloping supply curve. If, instead, the curve were horizontal, there would be no difference in outcome between the buyer market power and competitive scenarios in terms of both quantity purchased and price. There is quite a lot of

evidence that firms in general tend to operate on horizontal sections of unit cost curves, implying no impact from monopsony power. And if the supply curve were actually downward sloping, the single buyer would buy more at a lower price. So the assumption made about the shape of the supply curve has a considerable bearing upon the outcome. The problem in applying this model is that even if it were to be the appropriate one to use for the wholesale groceries markets, which is doubtful, it is not clear which shape of supply curve might be the correct one, and the shape could vary across different types of suppliers.

342. In practice, the supplier sides of the markets for a number of grocery products are also highly concentrated: examples include milk, dairy products, bread, flour, frozen food and sugar. For many products there are two or three major suppliers, just as on the demand-side there are only two major buyers. The relevant model would seem to have to incorporate some degree of market power on the suppliers' side as well. This suggests that a bargaining framework would seem to be more appropriate one with which to model the wholesale groceries market. However, such markets are difficult to analyse as outcomes depend very much upon the relevant bargaining power and skills of the two sides.
343. Grocery suppliers have argued that the supermarket chains already have considerable buyer power. The Commission has been presented with such claims in a number of previous adjudications. Supermarket chains have been able to use their buying power in a range of ways:
- They have an important impact on competition through the criteria they use for determining which brand they stock, and the position they accord it on the shelves. Criteria typically include discounts, special offers, promotional support and the promotional incentives offered by suppliers.
 - For some products the suppliers undertake the “merchandising”, such as the refilling of the supermarket shelves for milk and bread on a daily basis, meaning that supermarkets have no stockholding or warehousing costs.
 - Supermarkets also use housebrands as a competitive weapon. When these brands gain significant market shares, the housebrand contracts are keenly tendered for by the major suppliers, even though this gives the supermarkets the ability to drop prices and create extra leverage over the suppliers' own brands.
 - The supermarkets recognise that market share is important for their suppliers, and competition for prime shelf price is intense. Smaller suppliers have found access to supermarket shelves difficult because of their inability to match discounts offered by larger suppliers, and by an inability to supply the whole chain.
344. However, the Commission considers that major suppliers of groceries are not helpless in the face of the buying power of the supermarket chains. For example, they have attempted to counteract this buying power through sophisticated brand management techniques. One approach is to appeal directly to consumers over the heads of the supermarkets by differentiating and promoting certain brands to develop strong consumer loyalty. This potentially has a number of advantages: it makes the demands for those brands relatively price inelastic, and thus comparatively insensitive to price cuts on other brands; the supermarkets are encouraged to stock the heavily promoted brands or risk

losing the patronage of customers; and the supermarkets focus their efforts to squeeze price discounts or other concessions from suppliers on non-premium brands.

345. Grocery suppliers may also gain economies from supplying large orders to the supermarket chains, including from housebrand contracts. Overseas, it has been suggested that they are able to cross-subsidise through charging higher wholesale prices to non-supermarket buyers, such as the route trade.
346. The preceding analysis suggests that the buyer power of the supermarket chains, insofar as it exists and is not countered by supplier power, could impact on market outcomes in various ways, and could in some circumstances adversely affect competition and harm consumers:
- Large buyers could extract lower wholesale prices from suppliers. If these buyers also have market power over consumers, they could maintain higher retail prices and pocket the difference to earn higher profits. However, lower wholesale prices could also be passed on to customers in lower retail prices, if retail competition were effective.
 - The pressure to lower wholesale prices could impact on suppliers in various ways. They might become more efficient; they might attempt to raise wholesale prices to other retailers lacking in buyer power; or they might be discouraged from making investments in process and product innovation, as well as in maintenance, if expected returns are reduced.
 - Consumers could be harmed by higher retail prices and a lower rate of innovation and product quality, or benefit from lower prices and improved efficiency and investment.
347. In summary, the presence of buyer market power is not always easy to determine, and its impact on competition in the wholesale groceries market could vary, depending upon the circumstances of each supplier of the thousands of SKUs carried by supermarkets.

Competition Analysis

348. Each of the three Foodstuffs cooperatives is to some extent autonomous in its purchasing of food, liquor and groceries from suppliers. However, since the acquisition of Woolworths NZ by Progressive in 2002, Foodstuffs has moved to centralise more of its purchasing. Foodstuffs has formed a national buying entity—Foodstuffs Own Brands Limited (FOB)—owned one-third each by the three cooperatives, whose function is to negotiate trading terms and pricing with national suppliers who supply the same goods to each of the cooperatives. In addition, FOB negotiates with suppliers in respect of products purchased under Foodstuffs' private label brands. This development might be viewed as Foodstuffs strengthening its buying power by concentrating its main purchases in a single buying entity.
349. As well as purchasing food, liquor and groceries at wholesale for on-sale through its supermarkets, each of the Foodstuffs cooperatives operates a cash-and-carry operation that services dairies, service stations, catering and institutional customers in their respective regions. These subsidiaries are listed in Table 9.

Table 9: Foodstuffs' cash-and-carry operation

Cooperative and Associated Cash and Carry Subsidiary
Foodstuffs (Auckland) – James Gilmour & Co
Foodstuffs Wellington – Toops Wholesale Limited
Foodstuffs (South Island) – Trents Wholesale Limited

350. Foodstuffs advised the Commission that the aggregated turnover of these three entities for the year ending 28 February 2006 was [], and that around [].⁶⁴ Foodstuffs has a much higher share of purchases from the wholesale market than Woolworths, because in addition to its supermarkets, Foodstuffs also has its cash-and-carry operations that services dairies, service stations, catering and institutional customers.
351. Woolworths advised that, in contrast with the Foodstuffs' model, it maintains centralised control over purchasing decisions, which it carries out from its head office in Auckland. In addition, Woolworths, through its wholly-owned subsidiary, Wholesale Distributors Limited, is the food, liquor and grocery wholesale supplier and coordinator of the Fresh Choice and SuperValue supermarkets. The 14 franchised Fresh Choice and 34 SuperValue supermarkets are located mainly in the South Island.
352. Supermarkets are a very important distribution outlet for most suppliers of FMCG (fast moving consumer goods) in New Zealand. As the markets (viewed nationally and locally) are highly concentrated, each supermarket chain is likely to have strong negotiating strength. For example, soon after acquiring Progressive in 2005, Woolworths began renegotiating trading terms with its suppliers in a bid to harmonise trans-Tasman prices. According to a number of suppliers, Woolworths was very aggressive in those negotiations. [], advised the Commission that during [] negotiations with Woolworths, Woolworths ceased all promotional activity of its products for [] months. [] said that as a result of this Woolworths was able to negotiate lower prices.
353. [] further advised the Commission that Foodstuffs had already squeezed suppliers on price. In addition, Foodstuffs and Woolworths continue to apply pressure to suppliers to ensure that neither of the supermarket chains is getting a better deal than the other. He stated that:
- . . . they look at each other's pricing, you know, and if they see a price that they couldn't match they'll be on the phone and saying what's going on, are they getting a better deal than me and there'll be pressure. And, so suppliers are pretty wary of making sure they're even-handed because they know that people move around in the industry.
354. In summary, he stated that "they (the supermarkets) are our masters". Other suppliers interviewed by the Commission endorsed this view.
355. The central issue in the present case is what impact the acquisition of The Warehouse by either supermarket chain would have on buyer power in the national wholesale market for groceries.

⁶⁴ Tony Carter, Managing Director, Foodstuffs (Auckland), at an interview with Commission staff, 14 March, 2007.

356. Initially the proposed mergers would be likely to result in a very small increment nationally in buyer concentration, assuming that the successful purchaser were to continue with The Warehouse's existing grocery retailing operations. The size of The Warehouse's prospective buying market share can roughly be estimated on the basis of its share of the total number of supermarket stores: if it were to open [] stores its share would be about []; with 15 stores its share would be about []. This assumes that its stores would on average account for the same turnover of groceries as the average for all stores. This figure appears to the Commission to be of the right order of magnitude. Over time, The Warehouse's national share of purchasing would increase further if it rolled out more Extra supercentres. It is important to remember that although The Warehouse's share of the national wholesale groceries market may be quite small, its market shares in particular local supermarket retailing markets are much more significant.
357. The increment of [] in the national market share of wholesale grocery purchases by one or other supermarket operator appears to be small, although could increase in the future as more Extra supercentres are rolled out. Nonetheless, grocery suppliers have expressed concerns about the increase in buyer power that would result from either of the proposed mergers.
358. For example, [], advised the Commission that "life as a manufacturer is extremely difficult due to the power of the two supermarket chains". The firm advised the Commission that The Warehouse is the "one ray of hope" in New Zealand for a third supermarket retailer. Presumably, what it had in mind was that if The Warehouse were to gain sufficient market share at the expense of the two incumbent supermarkets, so that market shares became more evenly matched, the two incumbents would as a result have less buyer power. Although the Commission would accept this as a possibility, it is very doubtful that at the low levels of market share projected for The Warehouse, this effect would become manifest.
359. The Commission received a submission from an anonymous group of suppliers expressing concern at the potential impact on supermarket buyer power from the acquisition of The Warehouse. As the Commission was unable to test this evidence by talking to these suppliers, it is difficult to place much weight on their submission. The submission was that as the entry of The Warehouse had provided suppliers of FMCG with an alternative for supply of their goods, the acquisition of the Warehouse by either Foodstuffs or Woolworths would increase the monopsony power of both Foodstuffs and Woolworths.
360. However, The Warehouse told the Commission that although suppliers had welcomed it into the market, and were generally sympathetic, []].

361. After reviewing this information, the Commission considers that it is unlikely for the foreseeable future that mainstream grocery suppliers can credibly threaten not to supply either of the incumbent supermarket chains unless their terms of trade (prices or positioning) are improved, by having another channel to the market, via The Warehouse. The Warehouse does not have the market penetration necessary to provide this option for mainstream grocery suppliers, nor will it likely attain such a level in the short to medium term. The Warehouse might be a more realistic option for non-mainstream suppliers of groceries but, likewise, they may also have other retail outlet options.
362. A final consideration concerns the possible impact of supermarket buyer power on consumers in the retail markets. Woolworths told the Commission that it has extracted some savings from negotiations with trans-Tasman suppliers following its acquisition of Progressive, but that it had passed back those savings to consumers. Woolworths further advised that
[

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363. Without examining the position of each and every one of the many suppliers to supermarkets, it seems unlikely that the loss of The Warehouse as an independent grocery buyer would have a noticeable effect on the buyer power of the incumbents. The Commission recognises that, in the future, the Warehouse's share of purchases in the wholesale market could grow as it rolls out more supercentres. However, because the market for the wholesale supply of groceries is national, The Warehouse's share of purchases is likely to be far lower than its share of retailing in local supermarket markets. In any case, in the future, it is far from certain that any increased ability for purchasers to negotiate lower prices from suppliers would be harmful to competition, especially if these lower prices are passed on to consumers.

Conclusion on National Market for the Wholesale Supply of Groceries

364. The Commission is satisfied that, should the acquisition proceed, there is not likely to be a substantial lessening of competition in the national market for the wholesale supply of market as the result of enhanced buyer power on the part of the supermarkets, relative to what would be expected in the counterfactual.

DETERMINATION ON NOTICE OF CLEARANCE

368. Pursuant to section 66(3)(b) of the Commerce Act 1986, the Commission determines to decline clearance for:

- the acquisition by Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-operative Society Limited and Foodstuffs South Island Limited, or a company wholly-owned by those parties to acquire up to 100% of the ordinary shares in The Warehouse Group Limited; and
- for the acquisition by Woolworths Limited or any interconnected body corporate of Woolworths, of up to 100% of the shares in or assets of The Warehouse Group Limited and/or of any interconnected body corporate of The Warehouse Group Limited.

Dated this 8th day of June 2007

Paula Rebstock
Chair