Submission on market study into the retail grocery sector

As a private equity investment professional, I regularly assess the economics of a wide range of businesses, many of which are essential to the proper function of the New Zealand economy and underpin the quality of life of all New Zealanders.

Across these businesses, including those in such essential industries as energy and healthcare, it is incredibly rare to see a business that sustainably generates a return on invested capital above 20% without a natural monopoly industry structure or other hard barriers to entry. With an appropriate capital structure and level of debt, the supermarket duopoly (Progressive and Foodstuffs North and South Island) should be able to generate 30-40%+ returns on their invested equity – a return that an energy or healthcare executive could only dream of.

Nearly all New Zealanders will have heard the barbeque anecdote of a friend-of-a-friend who was lucky enough to open a supermarket franchisee and quickly obtained wealth that most people could only dream of. What the Commission's draft report shows is that there is truth to these anecdotes – a 20%+ return on capital, and even higher return on equity, allows an investor to double their investment every couple of years.

Return on invested capital is the best metric to judge the proper functioning of a mature market, because it is the fundamental judge of a firm's profitability. If the return on capital in a mature market is sustainably above that generated in comparable markets and a theoretical fair return by a wide margin, then that market is simply not functioning competitively.

I expect that the supermarket duopoly will focus on operational examples of competition in lobbying for only soft change, for example focusing on specific examples of competition in pricing or innovation in service offerings. However, the Commission should treat these examples as noise that do not provide real value in assessing the competitive functioning of the market. Ultimately, if the examples of competition given were real, then the supermarket duopoly wouldn't have earned the return it has earned over the last 5 years as identified by the Commission.

Similarly, the return on capital earned by the supermarket duopoly provides a huge incentive for a new entrant to the market. The fact there has not been a meaningful new entrant to the New Zealand supermarket market indicates there are hard barriers to entry under the current market structure. Those barriers to entry provide the moat by which the supermarket duopoly can continue to earn outsized returns, paid for by every day New Zealanders.

The supermarket duopoly will lobby for soft changes such as the introduction of a code of conduct, however these soft measures will do little to change the fundamental anti-competitive behaviour in what is a highly vertically integrated duopoly market. Instead, the Commission should take whatever steps are necessary to facilitate a meaningful nationwide new entrant to the New Zealand supermarket market within the next few years – anything less will not deliver competition and a fair deal to New Zealanders. That will likely require real intervention from the Commission such as the forced divestment of retail stores, or vertical separation of wholesaling from retailing. The Commission should be quick to remember its own success in the vertical separation of Telecom in 2011 and the value delivered to New Zealanders though lower priced telco plans.

The excessive profitability of the supermarket duopoly today is not a victimless construct – every dollar of excess comes from the back of the New Zealand public in their high supermarket bills.

I implore the Commission to do whatever is necessary to facilitate a scale nationwide new entrant into the New Zealand supermarket market in the next few years. Anything less will not deliver fair value to New Zealanders.