NZSCA SUBMISSION TO COMMERCE COMMISSION ON PROPOSED MERGER OF FSNI AND FSSI BUSINESSES

Introduction and summary of the NZSCA position

The New Zealand Specialist Cheesemakers Association (NZSCA) is making a submission as an industry body representing small to medium sized (SME) enterprises who make specialty cheeses primarily for sale in the domestic market, through retail sales channels. For the purpose of clarity, [redacted], which is a member, has submitted separately to the Commission.

New Zealand cheesemakers are an interesting case study for the impacts of both the current, concentrated grocery market and the even more concentrated market that would result from the proposed merger. The only access to the New Zealand consumer market at scale for specialty cheesemakers are the 'regulated grocery retailers (RGR)'. The permission these retailers wield to access the New Zealand retail market, the enormous disparity of scale and the consequences of their decisions give the RGRs extreme asymmetry of market power in the specialty cheese sector.

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The NZSCA already see that its members' business fortunes are tied to RGR ranging decisions – which are de facto decisions on allowing consumer market access. Any further concentration in decision making through a Foodstuffs merger would make many of these ranging decisions quite literally an open or shut decision for the ongoing operation of NZSCA members.

Our submission will make specific reference to the recent centralised commercial ranging and terms negotiations initiated by Foodstuffs North Island (FSNI). We see these as a forerunner to the likely business dealings of the proposed merged entity. Their impact in reducing NZSCA member profitability, product breadth and market access has already significantly heightened the stakes of working with them. Its our assessment that with the proposed leadership of the proposed merged entity coming from FSNI that its new business models will also be brought over.

It's the view of the NZSCA that if national grocery operations are the logical goal of the proposed merger then a better solution for both suppliers and consumers is that Pak 'N Save (PNS) and New World (NW) are split in to two competing national grocery chains. This would increase competition for supplier products and create a competitive retail grocery market where there was real pressure on retailer pricing. It would break up the internal price coordination that Foodstuffs currently uses to discourage new retail entrants through low pricing and volume capture by PNS while maximising margin and profit through NW.

Our submission is structured around the key topic areas the Commerce Commission has invited submission on in its 16th July, Statement of Unresolved Issues (SOUI). The order of our submission broadly follows the structure of the SOUI.

Will the proposed merger substantially lessen competition in the New Zealand grocery market?

The view of the NZSCA is that the proposed merger will substantially lessen competition in the New Zealand grocery market. Foodstuffs already enjoys circa 60% market share in each island through two separate but coordinated businesses. With the market share advantages each entity currently enjoys they already create market asymmetry. If a single entity were to be granted 60% market share of the national market it would create a highly unequal market both on the supply and retail side. This is exacerbated by the 'double-teaming' approach of Foodstuffs where its two retail brands dominate in both low-price high-volume retail and in lower volume higher priced offers.

For NZSCA members the current asymmetry is most felt on the supply side with the two Foodstuffs able to insist on favourable terms and increased margins in return for market access.

The proposed merger would create a highly unequal, uncompetitive market with so much market access power to the merged entity that it would be able to command monopolistic terms and profits and have low competitive incentives to pass these back to consumers on the retail side.

Coordination implications of reduced competition

It is the view of the NZSCA that Foodstuffs and Woolworths (WW) are already de facto 'coordinating' their market pricing, in much the same way the petrol companies do. This was recognised by the Commerce Commission in its first report on grocery market where it recognised the lazy level of competition between the RGRs. They don't need to form tacit or indirect communication to do this and can simply use one another's highly visible pricing for price matching and indexing. The FSNI centralised buying model is a direct reflection of FSNI awareness of WW national terms and retail pricing. WW retail pricing is included in the FSNI ranging documents.

More recently, Newsroom has reported on Woolworths adopting postcode pricing. It observes that in the South Island this will result in overall higher prices. Given its overall dismal market share in the South Island and the fact that Foodstuffs already prices higher in the South Island this is hardly a sign of competitive market reflecting the normal rules of supply and demand. It's more akin to the regional variances in fuel prices, where prices are best where there is the most competition. This kind of margin enhancing pricing reflects poor competition for market share and, if it is not a tacit agreement, it is certainly an acceptance by each RGR of the others' market position.

NZSCA submits that intra-Foodstuffs pricing coordination should also be considered. There are already price point and margin requirements encoded for each of NW and PNS, with suppliers required to contribute pricing that enables both FSNI and Foodstuffs South Island (FSSI) to maintain their retail price and margin positions for NW and PNS. This effective coordination sees Foodstuffs manage New Zealand grocery market pricing with high and low positions protected. In some local geographies this is tantamount to cartel like behaviour as there is tacit agreement between owner operators through the group cooperative structure as to which demographic market segments each retailer will pursue.

An effective way to test this theory is to consider a model where NW and PNS were owned by separate entities. Would NW maintain its price premium position if it were competing for customers with PNS in a local environment? The answer is no. Conversely a PNS chain acting independently would compete across a wider range of price points with NW than it does now.

The NZSCA submit that consideration should be given to splitting up the NW and PNS brands and setting each free to be national grocery retailers. Although not as consequential breaking up Four Square in to its own retail chain would also be beneficial.

Such break up would bring real competition to the New Zealand grocery market. It would bring this competition right down to the neighbourhood level throughout New Zealand where all consumers stood to benefit. The NZSCA cannot see that existing pricing and margin demands could be sustained should PNS and NW stores have to compete against one another equally.

Could FSNI / FSSI store owners counter the central coordination of pricing

The experience of NZSCA members is that along with centralisation of buying and ranging, pricing is also centrally controlled. In both FSSI and FSNI currently, if prices are centrally maintained then individual stores have limited flexibility to adjust pricing in the SAP system. This is simply a system rule imposed by using the cooperative's SAP enterprise system.

In addition, there is a high level of commercial control around pricing in each retail brand. With online shopping, centralised promotion and national marketing it is not feasible for a single store to break out of the cooperative's pricing structures.

And, it is also not in the interests of store owners to do this since this price positioning is designed to maximise their margins and protect their positions in the market.

It is observed by NZSCA members that FSSI in particular has recently adopted a strategy of manipulating prices within categories, raising retail prices for some products where it feels it can take additional profits. This category approach to profit taking means some suppliers lose sales volume on their products while FSSI increases profits by manipulating its margin mix within a category, some products deliver volume, others margin. There is no consultation or prior warning to suppliers when this happens.

Unilateral effects of the proposed merger in upstream markets and increased bargaining power

The Commerce Commission poses the question, would a merged entity be able to impose a "Small but Significant Decrease on Price" (SSNDP) and would suppliers be able to find an equivalent alternative market in this case? The NZSCA response to this question is that our experience with FSNI in their recent commercial negotiations is that this is already happening and that a merged entity would have even more power to do this.

The specialty cheese category is going through its second round of the new commercial negotiations model with FSNI. It is the experience of NZSCA members that through margin and terms demands and retail price point expectations FSNI is seeking to extract compounding price decreases in the specialty cheese category. The effect for FSNI is to successfully achieve increasing margins in a sector where manufacturing and supply chain costs are increasing. Suppliers would not willingly provide these margins if there were effective other routes to market.

The supply to major grocery retailers constitutes its own market

Specialty cheese makers do not have any alternative retail channel with equivalent consumer reach to the RGRs. The concentration of purchasing power amongst three buyers already creates business peril. There are unique specification demands from grocery retailers which make moving the same products to other channels non-viable. There are no other competing routes to the consumer market with equivalent or substitutable volume in New Zealand. Thus, supply to RGRs constitutes its own business dominating market in New Zealand.

For SME members of NZSCA export is not a viable alternative to New Zealand retail. In the first instances are the direct logistical and market establishment costs for the volume they produce. Importantly also, the food safety compliance standards required by MPI to permit export outside Australia are beyond the resources of most SME cheesemakers to sustain.

Within the RGRs Foodstuffs already has such scale, geographic penetration and market share that it holds a unique position in enabling end-consumer access across New Zealand.

A merged entity would have such dominant market position that it would not have to respond to market pressure and would essentially become the market itself. In this case the market would really be reduced to the success or otherwise of ranging decisions with the merged entity. New Zealand consumers would only access a specialty cheese market that the merged entity deemed it commercially attractive to provide.

The ‘efficiency’ argument

Both FSSI and FSNI have made much of the efficiency that a merger would provide and how this would result in savings being passed on to consumers.

The NZSCA view is that efficiency is double sided: efficiency of upstream supply and administration and retailer efficiency.

A merged entity would provide limited upstream supply efficiencies for NZSCA members. Most are too small to supply to store via retailer distribution centres and so would continue to bear the costs of supply in their businesses.

Delivery costs are a cost that supermarkets insist are fully born by the supplier in the current unequal commercial power paradigm.

It is also the observation of the NZSCA that FSSI and FSNI have not felt any competitive pressure to hold or reduce distribution centre (DC) costs. In fact, these have been increased recently. The NZSCA sees no pattern where the merged entity would make market access cheaper by reducing DC costs much below any other alternative route to its stores. It would have no incentive to do so with such a high market share.

FSNI have also made the case that increasing centralisation and the rolling up of terms in to net-net pricing simplifies payments and reduces the costs of administration. This is somewhat true. However, balancing this has been an increasingly complex, time consuming and expensive range review process involving a very large spreadsheet, multiple versions and negotiation process that has become extremely demanding, not to mention high stakes for SME businesses seeking to engage with it.

NZSCA members who predominantly supply direct will not achieve supply chain or administrative efficiencies that overcome the purchasing power and margin shift enabled by the bargaining power of a merged entity. This is already the case and will worsen.

The constraint effect of other acquirers of grocery products

There is not sufficient scale or capability in other acquirers to impact the current major grocery retailers in the specialty cheese market, let alone a merged entity. Competitors are either too small (Farros) or don't sell higher priced discretionary purchases (The Warehouse).

The merger of Foodstuffs Auckland and Wellington

Although it was somewhat more efficient to deal with one entity there was no discernible efficiency 'dividend' for consumers. And so with no change in pricing or margin demands there was no net positive outcome for suppliers. The impacts of this merger are still being realised with the new commercial terms strategy of FSNI being enabled by the merger of the two regional entities.

The NZSCA argue that the impact of the proposed merger should not be measured in year one. It will be the cumulative impacts in following years that demonstrate the true impact of the consolidation of market power in such a large entity.

The countervailing power of suppliers

There are no individual suppliers or group of suppliers within the NZSCA – made up predominantly of provincial SME businesses who could defend themselves from the market power of the proposed merger with a defensive retail strategy. The capital requirements are beyond the scale of NZSCA members. And also, entrenched retail spending habits mean a countervailing response would also have to break consumer purchasing habits of a consolidated grocery shop across many product categories at a single shopping destination – being the local supermarket.

The implications of the merged entity having a single centralised buying office

A centralised national buying office for the merged entity significantly raises the stakes for any business engaging with the merged entity. The centralised buying model being adopted by FSNI provides a half-scale example of what is to come. The current FSNI ranging and terms negotiations will be discussed in detail. However, a national purchasing office for the merged entity would represent an existential threat to most NZSCA SME members, faced with a possible negative ranging decision by the merged entity. This is at the heart of enormous concentration of market power and negotiating asymmetry entailed in the proposed merger.

What is the counter-factual to the merged entity and centralised national buying. Example of FSNI emerging product management

The current situation with FSSI operating a distinctively different buying approach to FSNI provides NZSCA members with a more open route to market than the centralised and fixed ranging windows offered by FSNI. FSNI have claimed that they will maintain the ability to sell store by store, but in practice structures and roles are being set up to discourage this.

In the South Island suppliers are still able to approach stores directly to sell in a product. Stores support this through a process of applying for a product code (SAP code) for the new product. Once this product is set up at one store, the same code can then be used to sell in and extend the product's distribution to further stores.

Alternatively, a supplier may approach FSSI head office category manager and ask for a product to be host supported. This means the product is set up and maintained centrally. This may happen in conjunction with a formal ranging decision or in support of giving a novel or competitive product a chance in the supermarkets.

More formally a product may be presented in a ranging window and a ranging status may be allocated. This endorsement by FSSI head office is then used in selling to stores to achieve the distribution share that the ranging level proposes.

This ability to sell store by store was also the case in the North Island until recently. However, FSNI has centralised buying in to a 'lead negotiator' model with strict, high stakes ranging windows. This consolidation of purchasing decisions is part of an observed pattern where, while FSNI claims store owner operators can make their own purchasing and pricing decisions this is not the case in practice. Where such residual processes remain, FSNI is making it increasingly difficult for suppliers to make use of them.

The CEO of FSNI has insisted in the media that suppliers will continue to be able to sell in store by store. The NZSCA member observation is that this is being discouraged. Suppliers are funnelled in to a ranging process and head office vetting prior to being able to sell to stores. For new market entrants the recently established Emerging Products Category Manager (EPCM) acts to vet products and approve them for presentation to stores. In recent communications with NZSCA members the EPCM has communicated that in their opinion the 'need state' of consumers in certain products has been met and no further products in that product class are required.

The EPCM argued that it was unfair on existing suppliers of certain products for more products to be introduced to the stores and to the consumer.

As mentioned above the NZSCA views FSNI's emerging practices and processes as a forerunner of what will come in the proposed merged entity.

We do not view the gatekeeper role that FSNI is implementing into its business as providing a healthy and competitive market for either suppliers or consumers. FSNI through the use of its data tools (dunnhumby data) has assumed the role of decision maker for New Zealand consumers.

This is bad in the current situation. It will be even worse for consumers and suppliers if the merger is allowed to progress.

What is the likely impact of private label products in the case of the proposed merger

Private label products already hold the 'entry' price point for each product class. This has the effect of limiting supplier pricing power. It is done in tandem with margin demands and retail price expectations from the retailer. If margins are not met at expected retail price points then a supplier will likely not have access to a retailer's stores. Private label products also have the effect of absorbing sales volume from the market, reducing the scale that independent suppliers are able to achieve with their own brands. With their brands and volumes weakened suppliers are even more unhealthily dependent on the retailer who is simultaneously competing with them and taking up market volume that would enable suppliers to achieve scale and business resilience.

What is the role of the GICA in moderating the impacts of the proposed merger

NZSCA members have already seen that the RGRs have been able to 'flip' the GICA, using it to protect their interests. In particular this been through negotiating with suppliers on the opt out clauses of the code. Suppliers in the specialty cheese category experience specific instances of this. The ongoing provision of credits for stock that is unsaleable with a blurring of the lines between wastage and shrinkage. Expired stock is still generating credit requests even where it was in the effective control of the RGR. Rules around accepting any new products without an agreement in place for a retailer either at store or national level to delete the product. And the transfer of merchandising costs that should rightfully be born by the retailer back to the supplier.
In general the NZSCA sees that the power imbalance and market access control of the RGRs has enable them to both directly and tacitly manipulate the Code of Conduct to limit its impact to them and undermine the protections and balance it was supposed to bring to the grocery market.
Given the effectives of the current RGRs in doing this the NZSCA has no confidence that the current code would offer any protection moderating the impacts of the proposed merger.
As noted by the Australian grocery regulator in reviewing their code there is still a very real fear of retribution which has a chilling effect on suppliers using the code to protect themselves from retailers. It should be noted that individual member businesses of the NZSCA have this same fear and have thus agreed amongs themselves to use the NZSCA as the body to present this submission, rather than do it through multiple submissions from individual businesses.

The FSNI example in understanding the hollowing out of GICA protections through the threat of denial of access to consumer markets

A clear and in the NZSCA view, brazen, example of the hollowing out of the GICA protections is the FSNI insistence on charging suppliers for merchandising and implementing this just as the code was being rolled out.

For specialty cheesemakers in the first round of the commercial negotiations with FSNI over a year ago, providing a merchandising fee was not required. The category manager said at the time that FSNI recognised that specialty cheese in the 'Service Deli' area of the stores was historically not merchandised by suppliers and no charge would be applied to the many small businesses involved. In the current round of negotiations that position has been reversed completely. In the negotiations the entreaty to provide money to FSNI for merchandising was written this way:

"Merchandising support is positively recognised in the brand profitability and overall strategic role within FSNI.

• This term will be a percentage based on RSV which will be one term across your whole business.

• This is not considered as part of trading margin but will be considered as part of your total commercial offer. This is now included in the CPT file."

In negotiations with FSNI this has clearly been linked to providing FSNI the commercial outcomes that will result in positive ranging. At best this is coercive, but it is more simply stated as a threat. This insistence on being paid to merchandise is in spite of the code provision:

16(2)(f) *The retailer must not directly or indirectly require a supplier to make any payment towards the costs of any activity that is undertaken by the retailer in the ordinary course of carrying on a business as a retailer. The retailer's business activities includes the following (f) merchandising (for example, stocking shelves and setting up displays)*

Many suppliers have some form of field agency. The role of these agencies is to provide specific support to a brand in sales and retail presentation. This has grown up over years as a way of securing a competitive advantage in stores where retailers have held their own staffing levels and where a better shelf presence – stocking, presentation and placement secures additional sales. These services have always been in support of the brand to overcome the shortcomings of store staffing and to compete with other suppliers and have never been designed to fund store operations.

The FSNI argument is that a blanket category wide approach to merchandising is an equivalent offset to this service and supplier cost. In fact store merchandising is a normal retailer activity and the evidence to date is that no additional labour has been hired in any store that would justify the additional charge to suppliers.

In effect, insisting on an opt out of the code with the veiled threat of reduced ranging is a way for FSNI to extract more margin from suppliers.

The impact on NPD of the proposed merger

For NZSCA members the stakes of presenting NPD to a merged entity would be high. The investment in product development, capital and human development would need to be weighed against the real risk that a rejection by the merged entity would cut off access to 60% of the New Zealand grocery market. That makes any NPD decision a high stakes one.

It also appears from emerging experience at FSNI that NPD is being judged on novelty and differentiation from existing products. This means it is not enough for a cheesemaker to decide to enter a class of cheese type they do not currently make. In fact if FSNI determine that this 'need state' is being met by current suppliers this is a likely path for rejection. Instead suppliers have to take the riskier path of introducing and educating the market on a whole new cheese. This is no easy task for any business, let alone a SME operator.

It also removes from consumers the opportunity for a new supplier of an existing product to bring product excellence, pack formats, brand stories, provenance and of course price pressure to the market. Yet, these factors are vital in a well-functioning market with a vibrant range of products and wide range of consumer choice.

The FSNI example in understanding SKU rationalisation, supplier pigeon-holing, reduced inter-supplier competition and a reduced quality offer for consumers. FSNI determines access to markets.

In the current range review process for FSNI there has been clearly stated, significant reduction in SKUs in the category. These products will not be available for optional purchase by stores. They will be removed from the FSNI SAP system entirely. The competition amongst existing suppliers and new entrants then is to meet FSNI defined customer 'need states' within a reduced total number of stock points. The clear implication is for each supplier to make its best bid for the reduced number of product positions that remain. Providing good 'commercial outcomes' for FSNI is the price of access. This has a series of flow on consequences.

Suppliers are forced to focus on their highest margin lines, pushing them to consider a manufacturing focus on a reduced range, giving them a reduced ability to diversify income streams and reducing their business resilience.

Suppliers are allowed in to the consumer market once they meet the commercial needs of FSNI. Since FSNI has an internal focus on efficiency it seeks to limit the number of SKUs it keeps in each cheese type. Thus suppliers cannot compete equally and consumers miss out on a free market choice.

This should be emphasised. The FSNI model is essentially a pay to play model with FSNI licensing operators to enter the consumer market.

In the current FSNI range review there has been no requirement for tasting panels or product presentation. The range review is a financial exercise based on margin and retail price. The effect in the end is for cost to be driven from the product to meet these requirements. The consumer choice is reduced without them knowing it as suppliers remove quality from their products to meet the margin and price hurdles set by FSNI.

The NZSCA view is that 'margin transfer' between suppliers and the RGRs is already in play. This is a globally recognised problem in concentrated grocery markets. It takes effect in the ranging process and is a result of the market power of the retailers. To concentrate even more market power in to the proposed merged entity would only make this situation more unequal and increase the power of the merged entity to extract a monopoly like fee for access to consumers. While Foodstuffs argues it is not in its interests to drive suppliers out of the market the fact is that its current ranging and commercial partner criteria benefit large, high-volume, low-priced suppliers. We cannot see that a merged entity offers any supplier side benefits except to incumbents of scale.

How a reduction in supplier profitability reduces incentives for investment

All businesses run on a profit motive. Of course, the motivation is higher in some than others. For some artisan cheesemakers there is a lot of satisfaction in seeing a delicious cheese enjoyed by a customer. But the love alone is not the basis for a long-term viable sector. With margin transfer and diminishing supplier profitability the incentive to invest further in the business is reduced. This is inverse to typical risk / reward models. The risk of investing should correspond to greater profitability. With this fundamental economic concept thwarted by the power of the RGRs suppliers will look for higher returning sectors to invest in and New Zealand's food industry will be hollowed out.

This is a particular concern now as the focus is on the poor productivity of New Zealand businesses and the emphasis is on us as food producing nation. Productivity requires investment. Investment goes where the returns are proportionate to the risk. These conditions can't exist in an unequal market with no guarantees of consumer access.

The harm to consumers in the specialty cheese category if the proposed merger is successful

The NZSCA view of the proposed merger is that ultimately the consumer loses. It is in the interests of the proposed merged entity to limit choices and push higher stock turns through fewer SKUs. They are able extract higher margins from suppliers for this market access.

Suppliers can only find these margins by cutting cost and ultimately quality from their products.

The merger would be a disincentive for new suppliers to emerge and challenge incumbents. The merged entity through its analysis of consumer needs, based on existing suppliers will determine whether or which new entrants may compete.

The New Zealand market is already highly concentrated and not functioning well. Allowing further concentration is the antithesis of the open market access philosophy which underpins the New Zealand approach to business.

The NZSCA wish to oppose the proposed merger and calls on the Commerce Commission to continue its work in breaking up the current duopoly and helping to establish a healthier grocery retail market.

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