Economic effects of proposed merger of FNSI and FSSI

A report for Chapman Tripp

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1. Introduction

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

2. The purpose of our report is to describe the economic principles applicable for an assessment of a merger between competing buyers and to apply those principles as relevant to the proposed transaction.

3. Presently, FSNI and FSSI are separate co-operatives that present a uniform national bricks-and-mortar and online retail grocery offering through common brands, ie, New World, PAK'nSAVE and Four Square, as well as commercial wholesale businesses operated by each co-operative, ie, Gilmours (FSNI) and Trents (FSSI).[2] However, store owner-operators also have an ability to compete and make range decisions on a local basis.

4. The proposed transaction would merge the management and operational functions of the co-operatives' support centres. Individual stores would continue to be owned and operated by individual co-operative members.[3]

5. On 18 January 2024, the Commerce Commission (the Commission) released its statement of preliminary issues relating to the proposed transaction.[4] Among other matters, the Commission identified that it would consider:[5]

> the countervailing power of suppliers of grocery products to the Parties in markets in which the Parties acquire grocery products, compared to any buyer power of the Parties themselves – the potential constraint on the merged business from a supplier's ability to exert substantial influence on negotiations and whether any supplier power might increase or decrease with the Proposed Merger, or *whether the Proposed Merger would strengthen the buyer power of the Parties*…
>
> …
>
> would the loss of actual or potential competition enable the merged entity…to *lower prices paid to suppliers* for goods or worsen any terms on which it acquires goods where it is a buyer…[emphasis added]

6. The remainder of our report is structured as follows:

   a. in section 2, we set out the relevant economic principles for assessing mergers between buyers;

   b. in section 3, we apply those principles to the proposed transaction; and

   c. in section 4, we explain the application of those principles to fresh products.

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

[2] Foodstuffs North Island Limited and Foodstuffs South Island Limited, *Notice seeking clearance for the merger of Foodstuffs North Island and Foodstuffs South Island Limited*, 14 December 2023 (henceforth 'Application'), para 2.

[3] Application, para 5.

[4] Commerce Commission, *Statement of preliminary issues Foodstuffs North Island and Foodstuffs South Island*, 18 January 2024 (henceforth 'statement of preliminary issues').

[5] Statement of preliminary issues, paras 18.5 and 26.1.

2. Economics of mergers between buyers

7. In this section we set out the relevant economic principles for assessing mergers between buyers operating in the same markets, and the approaches taken by regulators to assessing buyer power in grocery markets.

2.1 Economic principles for assessing mergers between buyers

8. A merger between buyers may lessen competition if it removes or reduces competition between those buyers in a market. The Commission's mergers and acquisitions guidelines describe buyer market power as:[6]

> …the ability to profitably depress prices paid to suppliers to a level below the competitive price for a significant period of time *such that the amount of input sold is reduced*. That is, the price of the product is depressed so low that (some) suppliers no longer cover their supply costs and so withdraw supply (or related services) from the market. Such an outcome reduces the amount of product being supplied damaging the economy. [emphasis added] [footnotes omitted]

9. Importantly, the Commission identifies that a necessary criterion for buyer market power to be 'damaging' to the economy is that the amount of input being procured and then on-sold is reduced. Unless the amount of input sold is reduced, the economic presumption is that any change in the circumstances applying in buyers markets arising from a merger amounts only to a transfer between the supplier and the buyer.

10. Economists generally identify that a firm's interactions with its suppliers can be assessed by reference to either:

    a. a market framework, also referred to as a 'monopsony power' model, where buyers and suppliers operate in a single market for the relevant product; or

    b. a bargaining framework, in which buyers and suppliers bilaterally negotiate prices and terms.

11. The Commission identified this distinction as a relevant consideration in its market study into the retail grocery sector.[7]

2.1.1 Monopsony power framework

12. 'Monopsony power' refers to the ability of large buyers to profit by reducing the amount purchased below the competitive level that would otherwise apply when there are many sellers that, collectively, face increasing marginal costs of supply.[8]

13. Figure 2.1 illustrates the effect of the monopsony in a standard market framework and in particular that:

    a. in a workably competitive market, the equilibrium would be at point **1** with quantity Q_c and price P_c, ie, at the intersection of the **demand** and **supply** curves, because each buyer takes the price as given; whereas

    b. in a market involving a monopsonist, in order for the monopsonist to acquire more of a product, it must pay a higher price (ie, it faces an upward sloping **supply** curve), and it must pay that higher

[6] Commerce Commission, *Mergers and acquisitions guidelines*, May 2022, para 4.2.

[7] Commerce Commission, *Market study into the retail grocery sector*, Final report, para 8.22.

[8] OECD, *Purchasing power and buyers' cartels*, OECD Competition Policy Roundtable Background Note, 2022, p 10.

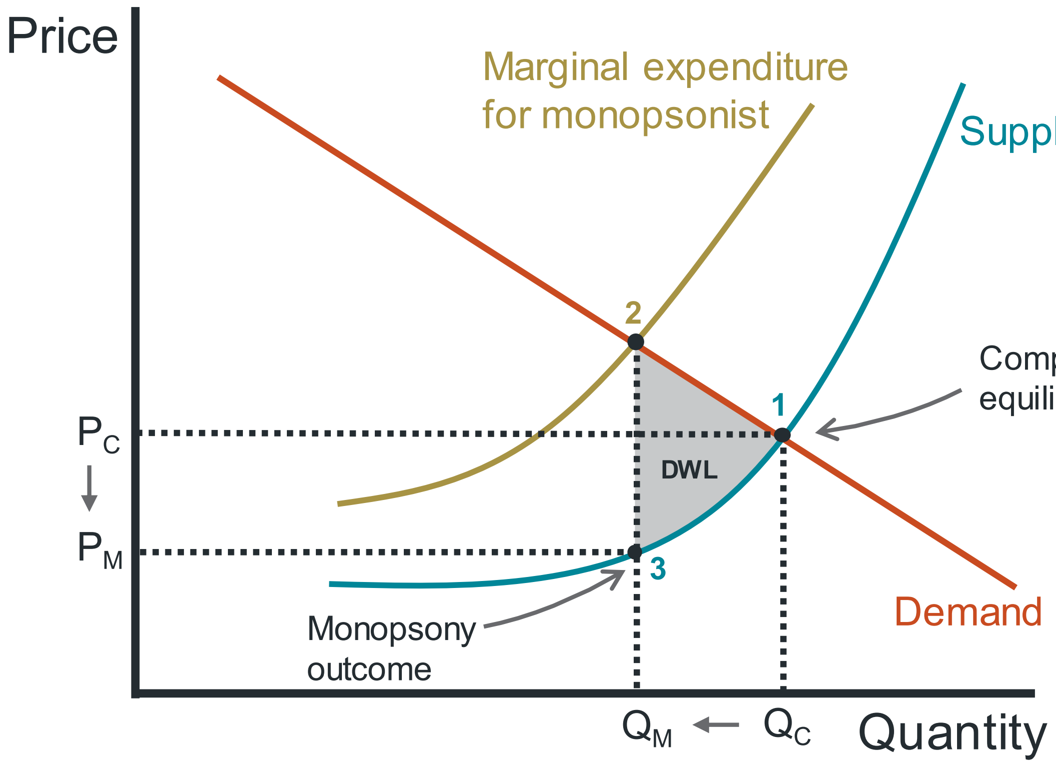
price for *all* units that it purchases – accordingly, its marginal expenditure on the product is represented by the **gold** line; so that

c. the monopsonist's profit maximising level of purchases is where its **marginal expenditure** on the acquired product is equal to the marginal benefit it derives from the product, ie, its **demand**, which occurs at point **2**; and

d. the monopsonist will therefore demand Q_M units of the product, resulting in a price P_M, ie, at point **3**.

14. In other words, figure 2.1 shows that, relative to a competitive equilibrium (**1**), a monopsonist has the ability and incentive to acquire a reduced quantity of the product and to pay a lower price (**3**). The extent of inefficiency – or, damage to the economy – is represented by the deadweight loss (DWL), being that shaded area in figure 2.1.

Figure 2.1: Deadweight loss from monopsony power



Source: Adapted from Carlton, D W and Perloff J M, Modern Industrial Organization, 4th Edition, Pearson Education Limited, Essex, 2015, p 107.

15. In assessing whether a substantial lessening of competition may arise from a merger between buyers where a monopsony power framework is appropriate, the extent of any potential lessening of competition depends not only on conditions in the upstream or input market, but also in the downstream market in which the relevant input product is on-sold.

16. Taking the upstream (input) and downstream (in which the input is on-sold) markets in turn:

a. in the upstream market, the ability of the buyer to command a reduced price and reduce the quantities for the input products it purchases depends on the extent of its buyer market power in that upstream market, ie, to the extent sellers in the upstream market are able to engage with alternative, competing buyers, a monopsonist will have no ability to force the market price and quantity below the equilibrium level; and

b. unless the buyer has substantial power in its downstream market, it will have no incentive to reduce the quantities it purchases in the upstream market, because it is likely to be more profitable for the firm to pass through at least some of any lowering of input prices into the downstream market and so compete more intensively in that market.

17. In summary, critical to the ability to exercise monopsony power in any input market is the absence of alternative buyers for sellers in that input market while, further, critical to the incentive to exercise any monopsony power a firm may possess in an input market is the existence of significant and sustained market power in the relevant downstream market.

2.1.2 Bargaining framework

18. In contrast to the monopsony framework, the existence of 'bargaining power' describes the strength of each of the parties in negotiation with the other. Unlike monopsony power, where the buyer faces a market-wide upward sloping supply curve, the relative degree of bargaining power cannot be expected to change the level of output that is agreed to be exchanged by a buyer and seller, and so the extent of their joint surplus. Rather, its primary effect is to change how the surplus is shared, ie, as set out by the OECD:[9]

> Bargaining power, all else equal, shifts surplus between buyers and sellers due to the reduction in purchase prices.

19. In economics, bargaining arises in circumstances where two or more parties have the opportunity to collaborate – in more than one way – for their mutual benefit.[10] In other words, bargaining can occur when all parties would share the resulting benefits. Where circumstances give rise to the question of how the benefits of cooperation may be divided, the parties must interact to reach an agreement that is accepted by all.

20. Bargaining theory draws on principles of bilateral exchange and game theory to model transactions involving negotiating to share a surplus.[11] It can be applied to inform questions such as:

a. under what conditions will a transaction take place?

b. if it does, how much would the buyer pay to the seller?

21. Bargaining models and their solutions are underpinned by two fundamental economic assumptions. Specifically, it is typically assumed that the outcome of the bargain is both:[12]

a. 'collectively rational' or 'pareto optimal', which means that there is no other agreement (or set of feasible agreements) that both parties would prefer; and

b. 'individually rational', such that the parties view the outcome of the bargain as no worse than the outcome they would otherwise have obtained.

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[9] OECD, *Purchasing power and buyers' cartels*, OECD Competition Policy Roundtable Background Note, 2022, p 14.

[10] Nash, J, *The bargaining problem*, The Econometric Society, 18, 1950, p 155 Von Neumann and Morgenstern originally analysed bargaining situations as non-zero-sum games, where n parties could interact and share in gains from trade. von Neumann, J and Morgenstern, O *Theory of games and economic behaviour,* 3rd ed, Princeton University Press, 1953, pp 556-557.

[11] For example, Edgeworth's seminal work in 1881 on voluntary exchange under individual and collective rationality assumptions provides a starting point for bargaining models, while the field was further developed under game theory by von Neumann and Morgenstern in 1944. Napel, S, *Bilateral Bargaining: Theory and Applications,* Springer Bern, Heidelberg, 2002, pp 5-8.

[12] See, for example: Wiese, H, *Advanced microeconomics*, SpringerGabler, Wiesbaden, 2021, p 408; Roth, A E, *Axiomatic models of bargaining*, Spring Verlag, 1979, pp 7, 8, 12, 14; and Binmore, K, *Fun and Games*, D.C Heath and Company, Lexington, Massachusetts, 1992, pp 176-178.

22. These fundamental assumptions give rise to two key elements of a bargaining framework, ie:[13]

    a. disagreement payoffs, or walk-away values, which refers to the most that a bargaining party can receive when acting independently or by walking away from the deal[14] – this concept is closely related to the 'outside option' available to a party, ie, its next best alternative; and

    b. the bargaining set, which is the set of potential bargaining outcomes acceptable to all parties and where there is no other outcome both parties would prefer.[15]

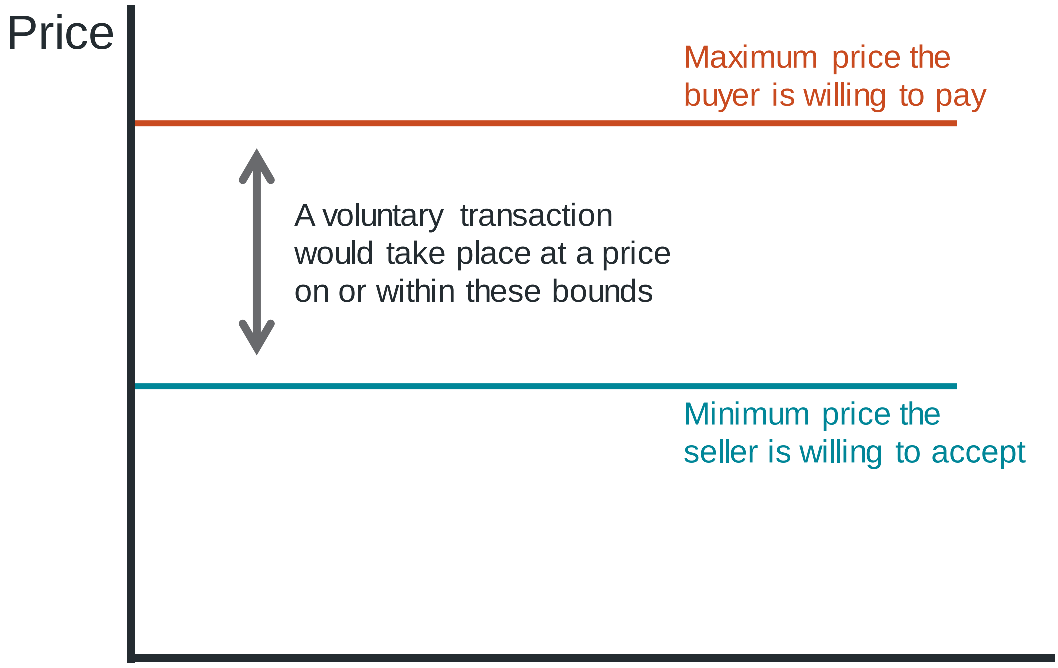
23. In a bargain between the buyer and seller of a product, the disagreement payoffs or outside options reflect:

    a. the maximum price a buyer would be willing to pay (WTP) a seller; and

    b. the minimum price a seller would be willing to accept (WTA) from a buyer.

24. This implies that the outcome of a bargain between two parties must lie between the buyer's WTP and seller's WTA, or between the two parties' walk-away values – illustrated in figure 2.2.

Figure 2.2: Bargaining solutions within the bounds of willingness to pay and accept



25. Importantly, the *quantity* of the voluntary transaction is independent of the price paid, so long as the price is within the bounds of WTP and WTA. This contrasts with the deadweight loss set out in figure 2.1.

[13] See, for example: Roth, A E, *Axiomatic models of bargaining*, Spring Verlag, 1979, p 5; and Binmore, K, *Playing for real: A text on game theory*, Oxford University Press, New York, 200, pp 464-467.

[14] Binmore, K, *Playing for real: A text on game theory,* Oxford University Press, New York, 2007, pp 468-469. Binmore refers to this as the breakdown payoff, which he describes as the payoff players receive from their best outside option.

[15] The parties' walk-away values or outside options determine the limits of the bargaining set under the individual rationality assumption. See, for example: Binmore, K, *Playing for real: A text on game theory*, Oxford University Press, New York, 2007, pp 468-469.

26. The outcome of a bargain within the range of feasible outcomes is specific to the circumstances and parties involved.[16] Economics can be used to establish the bounds of a bargain but it does not generally identify exactly where within these bounds the outcome of the bargain will lie.

27. However, economists have developed models where unique bargaining solutions can be found under various sets of assumptions.[17] These models provide insight into the factors that influence bargaining power and therefore bargaining outcomes in practice. For example:

   a. the rate of time preference and the extent to which delay is costly (often referred to as 'patience'), where, in general, it is favourable to one or other party's outcome to be more willing and able to accommodate delay/passage of time in negotiations, all else equal.[18] Parties that are said to be 'anxious for an early agreement' will have less bargaining power;[19]

   b. levels of initial wealth – linked to patience above, parties with higher levels of initial wealth (or 'deep pockets') may discount future payments at a lower rate than less wealthy parties because they are not anxious to receive additional income in the current period;[20]

   c. the level of risk aversion of the parties – in some cases, fear of disagreement or a breakdown in negotiations causes a highly risk-averse party to settle for more unfavourable agreements than the same party would if they were less risk averse;[21]

   d. ability to make a credible threat – parties that can make a credible threat that they will walk away from negotiations or force delays on impatient rivals can gain a larger share of the surplus;[22] and

   e. the extent of incomplete information about one or both parties' preferences, and extent of asymmetry in that knowledge – parties that are more informed about their rival's willingness to pay or accept may be able to use the information to gain a better outcome for themselves, or parties may not be able to make a deal at all.[23]

28. The economics literature does not recognise the existence of an 'imbalance' of bargaining power (or, indeed, a 'balance' of bargaining power), because increased bargaining power on the part of a buyer can promote economic efficiency.[24]

29. In an assessment of a merger between buyers, it is therefore critical to apply the relevant economic lens, including as to whether a bargaining or monopsony power framework is appropriate (including that both may be appropriate for different buyer/supplier interactions), because the economic consequences can differ considerably between the frameworks.

[16] In the economics literature, this is reflected in the modelling assumptions imposed, such as in relation to the preferences of the parties, rules of the bargain and completeness of information. See Napel, S, *Bilateral bargaining: theory and applications,* Springer Bern, Heidelberg, 2002, p 7.

[17] Napel, S, *Bilateral bargaining: theory and applications,* Springer Bern, Heidelberg, 2002, pp 73-74.

[18] Napel, S, *Bilateral bargaining: theory and applications,* Springer Bern, Heidelberg, 2002, p 39. By way of example, Rubinstein shows that, under a number of assumptions, in a bargaining situation with an infinite time horizon (ie, the parties can continue to make offers back and forth with no specified end point) the party with a lower fixed bargaining cost or that discounts the future at a lower rate (which is often described as being more patient) will take all of the gains from trade. Rubenstein, A, *Perfect equilibrium in a bargaining model*, The Econometric Society, 50, 1982, p 97.

[19] Binmore, K, *Playing for real: A text on game theory,* Oxford University Press, New York, 2007, p 472.

[20] Napel, S, *Bilateral bargaining: theory and applications,* Springer Bern, Heidelberg, 2002, p 20.

[21] Napel, S, *Bilateral bargaining: theory and applications,* Springer Bern, Heidelberg, 2002, p 20.

[22] Binmore, K, *Playing for real: A text on game theory,* Oxford University Press, New York, 2007, p 502.

[23] Binmore, K, *Playing for real: A text on game theory,* Oxford University Press, New York, 2007, p 494-495.

[24] van Doorn, F, *The law and economics of buyer power in EU competition policy*, Eleven International Publishing, 2015, p 102.

2.1.3 Implications of supplier market power

30. Mergers between buyers may also act to countervail power held by suppliers. Consistent with sections 2.1.1 and 2.1.2 above, this can be assessed either by means of:

  a. a market (or monopoly) power framework; or

  b. a bargaining framework.

31. Under the market power framework, suppliers with market power have ability to profit by reducing the amount sold below the competitive level.

32. Figure 2.3 illustrates the effect of a supplier with market power and in particular that:

  a. in a competitive market, the equilibrium would be at point **1** with quantity Q_c and price P_c, ie, at the intersection of the **demand** and **supply** curves, because each supplier takes the price as given; whereas

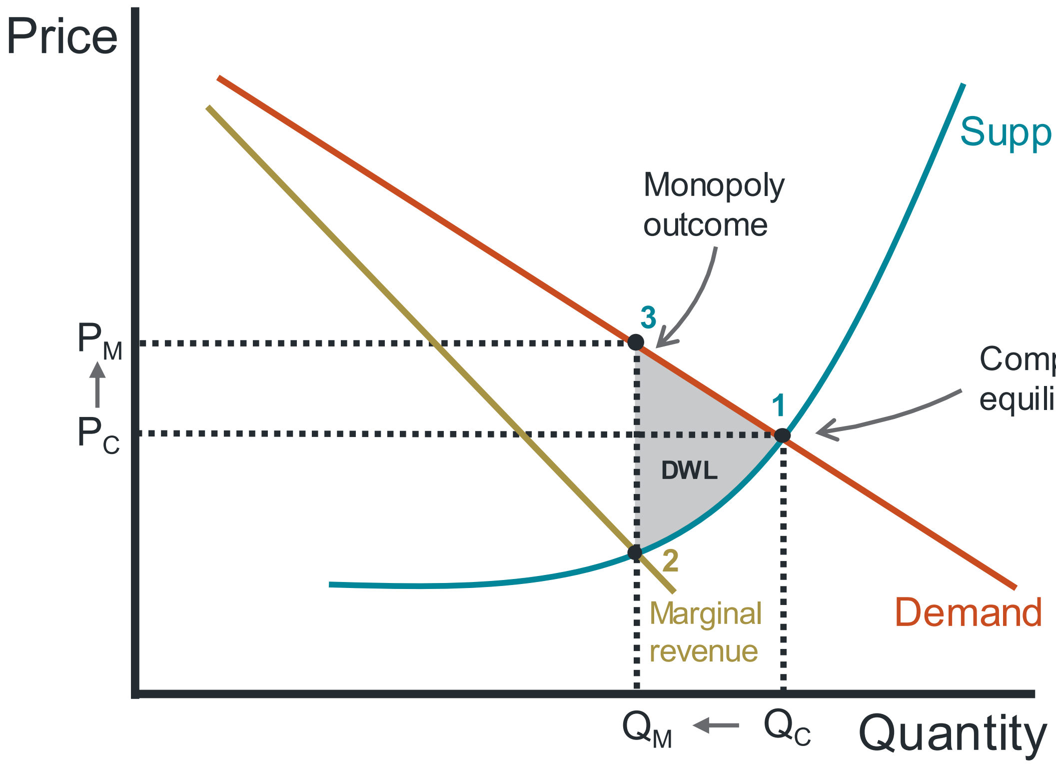
  b. in a market with a monopolist, in order for the monopolist to sell more of a product, it must lower the price it charges (ie, it faces a downward sloping **demand** curve), and it must charge that lower price for *all* units that it supplies – thus, its marginal revenue for the product is represented by the **gold** line; so that

  c. the monopolist's profit maximising condition is where its **marginal revenue** on the product is equal to the marginal cost it incurs from the product, ie, its **supply**, which occurs at point **2**; and

  d. the monopolist will therefore supply Q_M units of the product, resulting in a price P_M, ie, at point **3**.

33. In other words, figure 2.3 shows that, relative to a competitive equilibrium (**1**), a monopolist has the ability and incentive to supply a reduced level of the product for which it receives a higher price (**3**). The extent of inefficiency – or, damage to the economy – is represented by the deadweight loss (DWL) shaded area in figure 2.3.

Figure 2.3: Deadweight loss from supplier market power



34. If suppliers have substantial market or bargaining power in their dealings with buyers, then an increasing in bargaining, or countervailing, power resulting from a merger between buyers may result in:[25]

 a. an increase in output in the upstream market, ie, the opposite of that predicted in the monopsony framework; and

 b. an increase in welfare of consumers in downstream markets.

35. In other words, increased countervailing power of buyers, where a supplier holds market power, has the potential to offset (some of) the deadweight loss arising from that supplier's market power.

36. In an assessment of a merger between buyers, it is therefore critical to consider the extent of market power held by suppliers in the relevant market(s) and what the implications of a merger would be on *consumers*, rather than necessarily focusing on what may ultimately be a transfer between upstream and downstream firms.

2.2 Assessing buyer market power in groceries

37. Competition regulators around the world have on many occasions assessed buyer market power in the grocery industry.

38. In its 2022 market study, the Commission assessed that:[26]

[25] OECD, *Monopsony and buyer power*, Policy roundtables, 2008, p 10.

[26] Commerce Commission, *Market study into the retail grocery sector*, Final report, para 8.23.

> Most retailer-supplier relationships within the grocery sector fit within a bargaining framework. Grocery retailers and their suppliers typically enter into bilateral supply agreements, which detail the specific terms on which products will be supplied. Bargaining power and buyer power are key concepts within this bargaining framework.

39. This is consistent with the approach taken by the Australian Competition and Consumer Commission (ACCC) in its 2008 inquiry into the grocery sector.[27] The ACCC identified that the bargaining framework is:[28]

> …consistent with a wide variety of supply prices, terms and conditions, and does not predict that lower supply prices will be accompanied by lower quantities.

40. Importantly, bilateral bargaining tends to be the more appropriate model for reflecting relevant structural features of most upstream grocery supply and tends to be capable of predicting the observed outcomes of negotiations between retailers and suppliers more closely than its alternative, monopsony (or market) framework.[29] For example, the monopsony power framework predicts that there will generally be one price in each market, whereas prices paid by grocery retailers to suppliers tend to be based on bespoke, negotiated, bilateral agreements.

41. Consistent with the framework identified at paragraph 27, in its market study the Commission concluded that there were a range of factors that can affect a supplier's bargaining position with respect to grocery retailers, ie:

    a. ability of suppliers to export;

    b. availability of other domestic sales channels;

    c. strength of brand;

    d. supplier concentration;[30] and

    e. product perishability.[31]

2.3 Key implications of these alternative frameworks

42. The principal insight from the different models of interactions between buyers and suppliers is that an assessment of a merger between buyers needs to take careful account of the commercial realities by which buyers and suppliers interact in the factual and counterfactual, with a view to informing:

    a. first, whether those commercial realities by which buyers and suppliers interact give rise to concerns as to the potential establishment of monopsony power in retail grocery input markets, ie, the ability to drive both prices and quantities for the wholesale supply of grocery products below the competitive level; and

    b. second, even if the potential establishment of monopsony power can be shown to be likely, the extent to which the merged entity has or would have sufficient power in retail grocery markets for

[27] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p 311. The UK Competition Commission (now Competition and Markets Authority) similarly applied the bargaining lens in its 2008 review, eg, '…may affect the relative **bargaining position** of grocery retailers and their suppliers. We wish to ensure that grocery retailers are able to **negotiate** the best possible price from their suppliers…[emphasis added]'. United Kingdom Competition Commission, *The supply of groceries in the UK market investigation,* Final report, April 2008, p 16.

[28] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p 312.

[29] See, for example: ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p 311.

[30] See also section 2.1.3.

[31] In particular, this is relevant to the relative 'patience' that each party to negotiations may have.

it to have an incentive to exercise any monopsony power in the relevant wholesale grocery supply market.

2.3.1 Assessment of wholesale grocery supply effects

43. It is important to assess potential competitive effects in relation to markets for the wholesale supply of groceries according to the circumstances applying in each relevant market, because the market context and, accordingly, the commercial relationships that suppliers have with FSNI, FSSI and individual Foodstuffs stores, are likely to differ significantly, from supplier-to-supplier. This is consistent with the Commission's earlier conclusion that:[32]

> [s]ome suppliers have stronger relative bargaining power than others.

44. In other words, it is likely to be a fundamental mischaracterisation of the diverse commercial realities to contend that '…supply occurs at a national level...'[33] for the acquisition of all grocery products. Rather, the wide range of types and circumstances of suppliers of grocery products calls for a more nuanced assessment, which we set out in the sections below.

2.3.2 Assessment of retail grocery market effects

45. In contrast to many merger transactions that involve the aggregation of two parties that, in the factual, will be acquiring at least some inputs from within the same markets, under the proposed transaction there will be no changes to the merged entity's incentives to compete in downstream retail grocery, as compared with the status quo counterfactual. It follows that there is no difference between the factual and the counterfactual in terms of the strong incentives of the parties to compete downstream.

46. This important feature of the proposed transaction implies that, even if it could be shown that the parties had an increased ability to exercise any degree of market power in wholesale grocery input markets – which our application of the bargaining framework in sections 3 and 4 shows is not the case – they have no incentive to do so, on account of the detrimental effects on their ability to compete in downstream retail markets.

[32] Commer Commission, *Market study into the retail grocery sector*, Final report, para 8.49.2.

[33] New Zealand Food and Grocery Council, *Submission on statement of preliminary issues*, 19 February 2024, para 52.

3. FSNI and FSSI interactions with suppliers

47. In this section, we apply the economic principles set out in section 2 to that element of the proposed transaction with the potential to affect the Foodstuffs' entities' interactions with suppliers.

48. In its application to the Commission, Foodstuffs sets out that, at present, suppliers negotiate with:[34]

    a. in relation to FSNI:

        i. Gilmours stores;

        ii. Foodstuffs North Island; and

        iii. individual retail stores in the North Island; and

    b. in relation to FSSI:

        i. Trents;[35]

        ii. Foodstuffs South Island; and

        iii. individual retail stores in the South Island.

49. In a limited number of circumstances, the parties jointly procure from suppliers, ie:[36]

    a. FSNI and FSSI jointly own Foodstuffs Own Brands Limited, which negotiates with suppliers in respect of Foodstuffs' private label brands and is sold via each co-operative's stores; and

    b. for a limited number of other suppliers, such as arising where the co-operatives are together seeking to underwrite the emergence of additional competitors in a grocery category for which there is concentrated supply.

50. We assume that, in the counterfactual, this broad taxonomy of contractual relationships will remain the same.

51. If the proposed transaction was completed, suppliers would negotiate with, as relevant:[37]

    a. Gilmours stores and Trents, together;

    b. Foodstuffs, ie, the merged entity representing FSNI and FSSI; and

    c. individual retail stores in the North and South Islands.

52. Foodstuffs explains in its application that, following the proposed transaction:[38]

> …buying is likely to remain a mix of national, island-wide and local, reflecting supplier capacity, product constraints and consumer preference…

[34] Application, figure 5, p 33. We have excluded Liquorland from our analysis as this

[35] In the application, Foodstuffs explains that '…Trents is run under a corporate model at present, as a separate business division that sits within FSSI with its own management team.' Application, para 37.

[36] Application, para 128.

[37] Application, figure 6, p 33.

[38] Application, para 8.2.

53. From Foodstuffs' perspective, its suppliers can generally be categorised into three groups, ie:

a. major national suppliers, eg, Nestle, which are large suppliers that supply both FSNI and FSSI and have products sold at all or nearly all retail stores;

b. smaller national and regional suppliers, being those that supply one or both of FSNI and FSSI and may have products sold at many retail stores; and

c. small local suppliers, which generally supply groceries to only a few stores, and typically directly with those stores.

54. We address each such group of suppliers in the sections below.

3.1 Major national suppliers

55. Major national suppliers, such as Nestle, presently supply both FSNI and FSSI and have products sold at all or nearly all retail stores. We understand that these suppliers are likely to represent a large proportion of products sold at retail stores in the North and South Islands.[39]

56. These suppliers are likely to have strong bargaining positions, potentially derived from the strength of their brands or supplier market power. Such suppliers bilaterally negotiate with each of FSNI and FSSI, and there is a strong incentive for both parties to strike a deal, ie, the supply and procurement of groceries is 'collectively rational' for these suppliers and for each cooperative.

57. Under the proposed transaction, we assume that these suppliers will negotiate bilateral arrangements with Foodstuffs, instead of individually with FSNI and FSSI. The most relevant economic framework for these suppliers, ie, that which is consistent with the commercial realities, is the bargaining framework. Under these arrangements, suppliers are likely to face lower costs in negotiating with one buyer (Foodstuffs), rather than FSNI and FSSI individually.

58. In many instances, these major national suppliers are likely to represent 'must have' suppliers that Foodstuffs would seek to ensure availability of in order to compete most effectively at the retail level – consistent with grocery retailers competing on price and non-price terms, such as on range.[40] In other words – setting aside the question of whether the FSNI and FSSI can even be said to compete for supply given their distinct geographic (retail) footprint – Foodstuffs' outside option would remain unchanged. These suppliers are likely to have significant (countervailing) supplier power over buyers.

59. The relative bargaining position of Foodstuffs, as compared to FSNI and FSSI individually, is likely to improve slightly, because Foodstuffs would be in a position to assess its business nationally, which is especially relevant for major, 'must have' suppliers. For example, in negotiating with a supplier under the present arrangements, FSNI can be expected to take into account its '…consistent national retail offering…and consistent brand positioning…' at the retail level and so may be relatively less certain as to whether FSSI would also be able to ensure supply. Each island-wide cooperative may therefore accept slightly higher prices from suppliers as a result of this uncertainty. Under the proposed transaction, this particular aspect of uncertainty would be removed, and so Foodstuffs may be in a marginally stronger bargaining position with such suppliers.

60. Indeed, it may be the case that, presently, suppliers agree different prices with FSNI and FSSI for the same product, as a result of differential bargaining outcomes. Under the proposed transaction, Foodstuffs would presumably seek to bargain for the better price/quality deal that each individual

[39] FSNI and FSSI state that '…there is a high degree of alignment in ranging as between the two co-operatives…'. This alignment in ranging must therefore be derived from national suppliers. Application, para 122. In 2021, 90 per cent of FSNI and FSSI's sales was derived from 228 and 198 suppliers, respectively. Commerce Commission, *Market study into the retail grocery sector*, Final report, para 8.64.

[40] See, for example, Commerce Commission, *Market study into the retail grocery sector*, Final report, para 4.7.2.

cooperative presently receives. The extent of Foodstuffs' ability to do so will also depend on the countervailing power of each individual supplier.

61. Consistent with the bargaining framework, provided that the bargaining parties have an option that is 'collectively rational', although the price and other terms may change with the transaction, both parties would want a bargain to be made and products to be sold. In particular, the quantity of products sold from suppliers to buyers would not be expected to fall, because Foodstuffs would continue to compete to the same extent at the retail level and at the wholesale supply level.[41]

62. In other words, even if prices that it paid to suppliers was to fall, Foodstuffs would continue to be incentivised to procure and retail the same quantity of grocery products to compete effectively and so to offer lower prices at the retail level.

3.2 Smaller national and regional suppliers

63. Small national suppliers generally supply groceries to both of FSNI and FSSI, ie, they negotiate individually with each co-operative, but are of a relatively smaller scale than the major national suppliers we describe in section 3.1. Regional suppliers are those suppliers that presently only negotiate with and supply to one of FSNI and FSSI.

Small national suppliers

64. Small national suppliers generally supply groceries to both of FSNI and FSSI, ie, they negotiate individually with each co-operative, but are of a relatively smaller scale than the major national suppliers set out in section 3.1.

65. These suppliers are likely to have less relative bargaining power than the major national suppliers.[42] However, these suppliers are still likely to:

   a. negotiate bilaterally with each of FSNI and FSSI, for which there will remains a strong incentive for both parties to strike a deal, ie, procurement of groceries is 'collectively rational' for these suppliers and each cooperative; and

   b. under the proposed transaction, face lower costs in negotiating with one buyer rather than each co-operative individually.

66. Consistent with the major national suppliers, Foodstuffs' relative bargaining position as compared to each of FSNI and FSSI individually is likely to improve slightly, because it could assess its business nationally. Consistent with the bargaining framework, provided that the bargaining parties have an option that is 'collectively rational', although the price and other terms may change with the transaction, both parties would want a bargain to be made and products to be sold. In particular, the quantity of products sold from suppliers to buyers would not be expected to fall, because Foodstuffs would continue to compete to the same extent at the retail level and at the wholesale supply level.[43]

67. In other words, even if prices that it paid to suppliers were to fall, Foodstuffs would continue to be incentivised to procure and retail the same quantity of grocery products to compete effectively and so to offer lower prices at the retail level.

[41] Notably, the parties' retail operations do not include any geographic overlap.

[42] See paragraph 27 for relevant factors that may affect relative bargaining positions.

[43] Notably, the parties' retail operations do not include any geographic overlap.

Regional suppliers

68. Regional suppliers presently only negotiate with and supply to one of FSNI and FSSI. These suppliers represent only a small proportion of suppliers to FSNI and FSSI.[44] Regional suppliers tend to supply only one co-operative as a result of:[45]

    a. consumer preferences; and/or

    b. supply constraints, including capacity and geographic/cost constraints.

69. Under the proposed transaction, these suppliers would instead negotiate with Foodstuffs. However, since these suppliers are constrained from supplying both islands by means of perceived consumer preferences or supply constraints, in practice this is likely to amount to negotiating for supply to the same stores as without the transaction, because these constraints are likely to remain following the transaction.

70. In other words, it is unlikely that the transaction increases Foodstuffs' bargaining power with respect to these suppliers. To the contrary, the combined Foodstuffs may have the ability to work more closely with the supplier to examine possibilities for alleviating supply constraints to retail the product more widely across the country.[46] The market outcomes for these suppliers are likely to therefore be no change or an increase in output.

3.3 Small local suppliers

71. Small local suppliers generally supply groceries to only a few stores and typically negotiate directly with stores.

72. We understand that individual stores negotiate terms with such suppliers:[47]

    a. in addition to the 'headline' terms agreed with FSNI or FSSI, individual stores may negotiate individual arrangements; and

    b. for the procurement of additional products, ie, outside the 'core' range, generally from small local suppliers.

73. These categories of suppliers that negotiate with individual stores would not be likely to be affected by the proposed transaction, because individually owned and operated stores can continue to negotiate directly with suppliers in respect of relevant local arrangements, whether with suppliers for which 'headline' terms have been agreed or not. Local stores will not in themselves have any change to their bargaining position relative to suppliers.

74. Demand for suppliers providing groceries that sit outside the 'core' range is likely to be derived from local consumer preferences or highly constrained suppliers,[48] which would not be affected by the transaction, and local owner-operators will continue to have the same incentives to supply these grocery products to their local customers. That stores are owner operated will continue to ensure these incentives remain, ie, they will still be incentivised to deal directly with suppliers.

[44] The application describes differences in range as being '…limited scenarios…'. Application, para 124.

[45] Application, para 124.

[46] This would be akin to the certain suppliers with whom FSNI and FSSI have a join arrangement to support competition in a grocery category with presently limited competition. See: Application, para 128.2(b).

[47] Application, para 128.4.

[48] Application, para 124.

75. In summary, suppliers negotiating directly with stores or groups of stores – whether over terms over and above the 'headline' terms or purely on an individual basis – will face an essentially unchanged bargaining landscape.

4. Application to fresh products

76. In this section, we describe the application of the economic principles explained in section 2 to fresh product markets, for which changing circumstances, primarily on the supply side, imply the existence of a more dynamic market environment.

77. Foodstuffs retails a wide range of grocery products to consumers, with these generally able to be categorised as either 'manufactured' or 'fresh' products. In this section, we explain the spectrum of supply and demand characteristics that apply to fresh products, review the options for suppliers of fresh products to sell their products and the implications for bargaining between buyers and suppliers.

4.1 Spectrum of supply and demand characteristics

78. Fresh grocery products – which can be further delineated into meat, fish and fresh produce – are characterised by a much more dynamic market environment than manufactured grocery products. Such dynamism principally arises from seasonal influences on the production of all forms of fresh product. Within this dynamism, there is also a wide spectrum of supply and demand characteristics that apply to different fresh products in New Zealand.

79. Some fresh products are sold domestically as well as into international markets. For example, a very large proportion of output from meat and seafood suppliers is exported to international markets.[49] To the extent that these producers supply domestically, the opportunity to export the relevant product forms a substantial part of those suppliers' outside options, and so their willingness to accept prices from grocery retailers in New Zealand.

80. In addition to meat and seafood, it is likely that international market factors also apply to other fresh produce suppliers – such as kiwifruit, apples and cherries – where a significant proportion of product is exported.

81. The bargaining framework set out in section 2 and applied in section 3 implies that, for these suppliers:

    a. the merger is unlikely to materially affect the relative bargaining positions of Foodstuffs and suppliers of such fresh produce;

    b. suppliers' outside option of exporting remains a key factor in their willingness to accept particular terms when negotiating with Foodstuffs (or any other buyer of grocery products);

    c. accordingly, it is very unlikely that Foodstuffs (or any other buyer) has the ability to exercise monopsony power, by forcing output and prices in these input markets below the competitive level; so that

    d. there is little risk of a lessening of competition in respect of these suppliers.

82. The remainder of fresh produce in New Zealand is generally characterised by market circumstances that are primarily domestic in nature. Some of these products may be highly perishable. For example, we understand that, in order to maximise the useful life of the products for customers, most produce is made available in store to Foodstuffs' customers the day after it is harvested by suppliers. In general, the perishability of such products implies the existence of more localised markets and supply arrangements than apply for non- or less-perishable products.

[49] See, for example: Commerce Commission, *Market study into the retail grocery sector*, Final report, footnote 1028.

4.2 Spectrum of supply options and implications for bargaining

83. For those products for which exporting is not a realistic option for suppliers, the range of channels to market available to suppliers has implications for bargaining outcomes.

84. We understand that suppliers of fresh products (depending on the product) can negotiate to supply their products to:[50]

a. fresh produce wholesalers, such as T&G Fresh, MG Fresh Produce Group and Fresh Direct;[51]

b. grocery retailers' cooperatives or national bodies, including FSNI, FSSI and Woolworths;

c. other grocery wholesalers, such as Bidfood and Service Foods;

d. individual grocery retail stores, including Foodstuffs' banners stores, international food stores (such as Tai Ping) and Farro Fresh;

e. specialist grocery retailers, such as greengrocers;

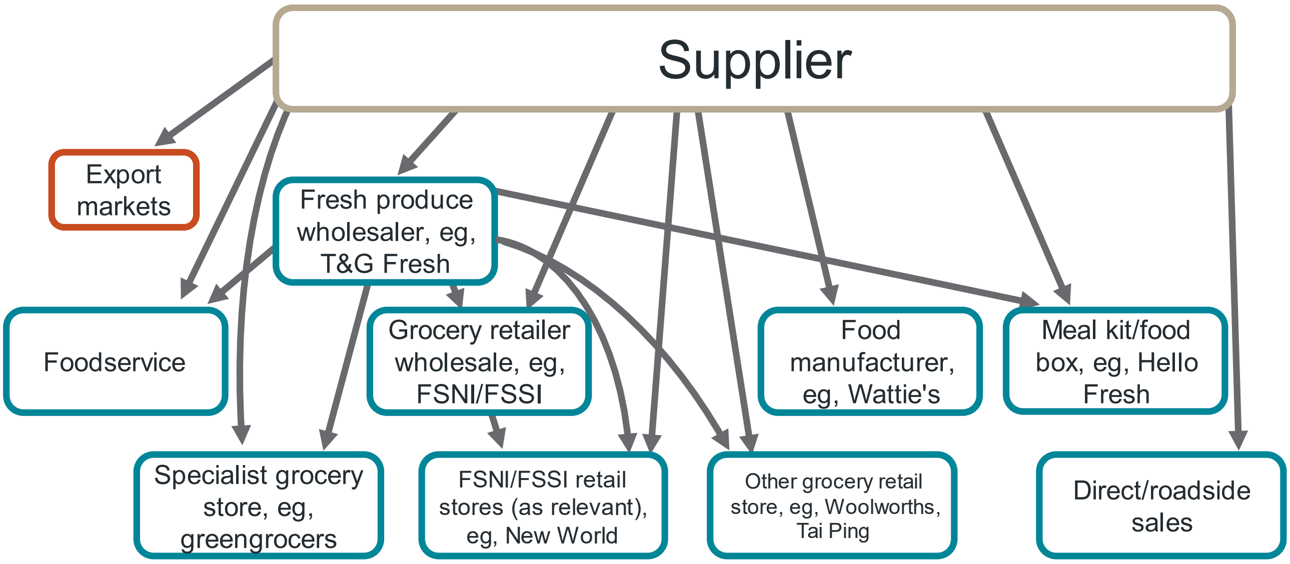
f. meal kit and food box providers, such as Hello Fresh, My Food Bag and Foodbox;

g. large foodservice providers, such as McDonalds; and

h. food manufacturers for further processing, such as Kraft Heinz (Wattie's).

85. We present the spectrum of options for supply available to New Zealand providers of fresh products in figure 4.1 below.[52]

Figure 4.1: Spectrum of options for New Zealand produce suppliers



[50] See, for example: Commerce Commission, *Market study into the retail grocery sector*, Final report, pp 10-11.

[51] We understand that there are at least six fresh produce wholesalers operating in New Zealand, including T&G Fresh, MG Fresh Produce Group, Primor Produce, Fresh Direct, Seeka and Carter & Spencer. United Fresh New Zealand Incorporated, *Fresh facts 2023: New Zealand's fresh fruit and vegetable industry,* December 2023, p 28.

[52] There are a range of other participants that we have not included in our simplified figure, such as importers, packhouses, online retailers, open-air markets. See, for example: United Fresh New Zealand Incorporated, *Fresh facts 2023: New Zealand's fresh fruit and vegetable industry,* December 2023, p 14.

86. In particular, figure 4.1 shows that suppliers have a spectrum of channels to market, that they may choose to participate in one or more such channels, and may choose to skip or engage with different functional levels of the supply chain for groceries in New Zealand. The presence of such diversity of end-markets for produce, and diversity of channels to those markets, is inconsistent with the potential for the proposed transaction to risk the establishment or strengthening of any degree of monopsony power.

87. Rather, for many such products, including potatoes, we understand that the food manufacture and foodservice provider channels generally account for substantial volumes, representing an important outside option for these suppliers – similar to the export option available to some suppliers that we explain in section 4.1.

88. Presently, FSNI and FSSI (as well as individual stores) negotiate both with individual suppliers and produce wholesalers, such as MG Fresh Produce. Grocery retailers, when facing multiple supply options for a particular grocery product, may make use of these different options as a means of price discovery, ie, to assist in evaluating the best prices available from different suppliers at different points in time. Grocery retailers can then use this information in their negotiations with suppliers.

89. These negotiations include myriad means by which produce from suppliers can be sold in retail stores, such as FSNI and FSSI banner stores. For example, growers can supply individual FSNI and FSSI retails stores by means of:

   a. a fresh produce wholesaler,[53] who in turn can supply:

      i. to a grocery retailer, such as FSNI or FSSI, which then on-supplies the product to one or more individual local stores; and/or

      ii. direct to one or more local stores;

   b. a grocery retailer, such as FSNI or FSSI, which then on-supplies the product to one or more local stores; and/or

   c. direct to one or more local stores.

90. The supplier-buyer purchase relationships that are affected by the merger are the relationships between FSNI/FSSI and its upstream suppliers, ie, fresh producers or fresh produce wholesalers. The suppliers of these products include:

   a. for some products, just one major supplier, such that no major buyer of that produce can avoid dealing with that supplier, and for which the merger is unlikely to have a material effect on the relative bargaining positions of Foodstuffs and these suppliers;

   b. fresh produce suppliers and wholesalers that operate on a regional or national basis, for which the merger is unlikely to have a material effect on the relative bargaining positions of Foodstuffs and those suppliers; and

   c. for other products, island-specific (or more localised) local suppliers of highly perishable produce that is not amenable to long distance transport, and for which the bargaining framework remains appropriate.

91. Further, to the extent that a change in the relative bargaining positions of Foodstuffs and these suppliers did occur and led to a reduction in prices paid to such suppliers, Foodstuffs' incentive to

[53] We understand that some fresh produce wholesalers have vertical relationships with some growers, such as MG Fresh Produce Group's co-operative model. See, for example: https://www.mggroup.co.nz/about-mg/about-mg/, accessed 5 March 2024.

compete in downstream retail markets implies that it would maximise profits by consequently offering lower prices to consumers.

92. We understand that the dynamic market environment that characterises fresh grocery product may lead to occasions where there is insufficient supply on a regional or nationwide basis to satisfy the typical demand in that area for a fresh product. As a matter of principle, the prospect of periodic shortages of a particular fresh grocery product – a situation that will alter the near-term shape of the supply curve – should not affect either the concepts or the application of the two forms of bargaining framework we describe in section 2.

93. Notwithstanding, in these limited circumstances, it may be that FSNI and FSSI seek to acquire the same, limited product, in situations where some customer demand must be curtailed to address the insufficiency of supply. Absent the transaction, there may be some limited, temporary competition between the two Foodstuffs entities during these periods, as the cooperatives (and other grocery retailers and the supplier's other customers) each seek to supply their respective customers (which, collectively, cannot all be satisfied). The net effect may be that, with the transaction, the prices paid to suppliers during these limited periods may be slightly lower – although, this outcome is far from assured because other grocery retailers and other customers (eg, exports, food manufacturers) may win a greater share of the supply that is available for their own customers. In any case, even during these periods, Foodstuffs' incentive to compete in downstream retail markets imply that its most effective competitive strategy would be to pass on those slightly lower prices to its own customers.

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