FOODSTUFFS SOUTH ISLAND LIMITED
SUBMISSION TO THE COMMERCE COMMISSION'S DRAFT REPORT ON THE RETAIL GROCERY INDUSTRY

EXECUTIVE SUMMARY – KEY POINTS

Foodstuffs South Island Limited (FSSI) has reviewed the Commission's draft report and has considered the draft findings and recommendations. This document is a summary of FSSI's submission to the matters and topics raised in the draft report.

FSSI has several key submissions in response to the Commission's draft findings, including:

- *Competition is working well* as the major grocery retailers and other retailers compete vigorously on price, quality and service. This is due to consumers visiting or using many different types of grocery retailers to get their grocery needs.
- *FSSI's Return on Average Capital Employed is less than half* that calculated by the Commission and consistent with International Grocery Retailers, sitting at approximately 11.5%.
- *New Zealand grocery prices are not high by international standards* and New Zealand places in the middle of the OECD.
- *FSSI is constantly innovating.* There are many examples of innovation by FSSI, and FSSI continually seeks to innovate with its retail offerings to its customers.
- *The cost price from suppliers is the single biggest component* in the price of groceries for consumers in New Zealand. This has not been fully investigated by the Commission as part of its market study. On average, the cost price from suppliers makes up approximately **67 cents of every $1** for products on supermarket shelves.

FSSI has considered the options recommended by the Commission, and comments as follows:

- FSSI **supports the introduction of a grocery code of conduct** and will participate in its development.
- FSSI will move **to clarify its promotions and pricing practices**.
- FSSI will review its **loyalty programmes to make the terms and rewards clearer**.
- FSSI **supports the freeing up of land for supermarkets** through planning law reform. FSSI is willing to give undertakings not to enforce restrictive land covenants on land it has sold and is willing to provide a commitment to not register covenants when selling land in the future.
- FSSI's view is that the **wholesale supply of groceries in New Zealand is functioning well**. The proposed wholesale interventions by the Commission are unproven and untested. It is unknown whether the Commission's proposals would ultimately provide any benefit to consumers.
- FSSI **does not support the separation of its co-operative** into wholesale and retail businesses. Further, FSSI does not see the benefit to consumers in any forced divesting of its stores.

Key Information from our Submission

The Foodstuffs South Island Cooperative

1 FSSI is a cooperative. The Cooperative is an integrated business made up of South Island (and Stewart Island) Retail Stores that are separate owner operated franchises, and the Cooperative itself which supports the stores. There is no wholesale/retail delineation between the two. The Cooperative owns the land and buildings used by many stores and as well as sourcing, and delivering products to stores, provides support services including ranging and promotional planning, retail execution support, marketing, IT services, developing and renting properties for new retail stores, transactional shared services, HR and legal support and training.

2 The Retail Stores are members of the Cooperative and the beneficiaries of these services (which they pay for) with their focus being on store "execution" and the customer experience.

The Commission's findings on Profitability

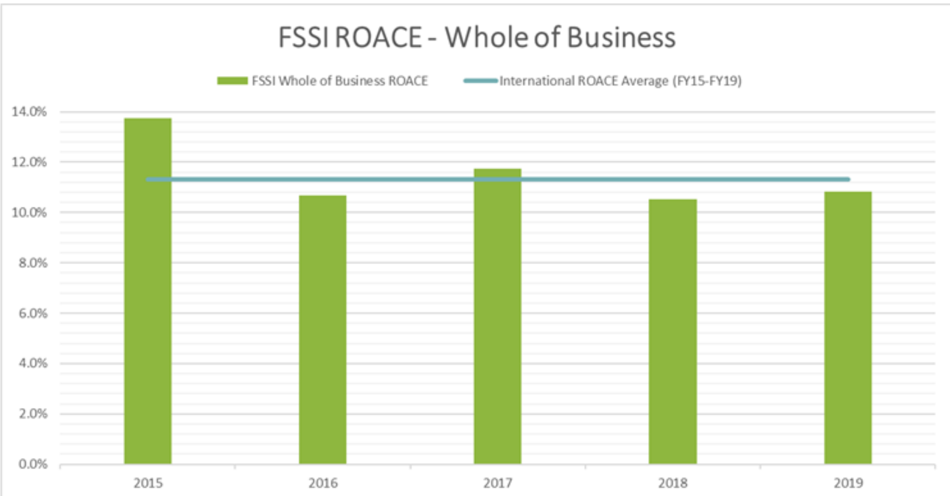
3 FSSI is an integrated wholesale and retail co-operative. Despite this, the Commission has chosen to calculate FSSI profitability by artificially separating the Cooperative from the Retail Stores. FSSI does not agree with this approach to calculating profitability for reasons outlined in our submission.

4 In FSSI's view, the profitability calculation should have been done on a "**Whole of Business**" basis. A Whole of Business assessment:

- Reflects the actual real-world operations of FSSI;
- Avoids subjective estimations and assumptions;
- Is consistent with how the assessment of Woolworths profitability was carried out;
- Is consistent with the Commission's international sample of grocery retailers, most of which are fully integrated businesses.

5 Using a Whole of Business assessment, FSSI's return on average capital employed (ROACE) is **an average of 11.5%** over the 2015 – 2019 period. This is approximately half of the profitability calculation produced by the Commission.

6 This level of return is also consistent with the ROACE of the international sample of grocery retailers which was calculated by the Commission to be around 11.3%.

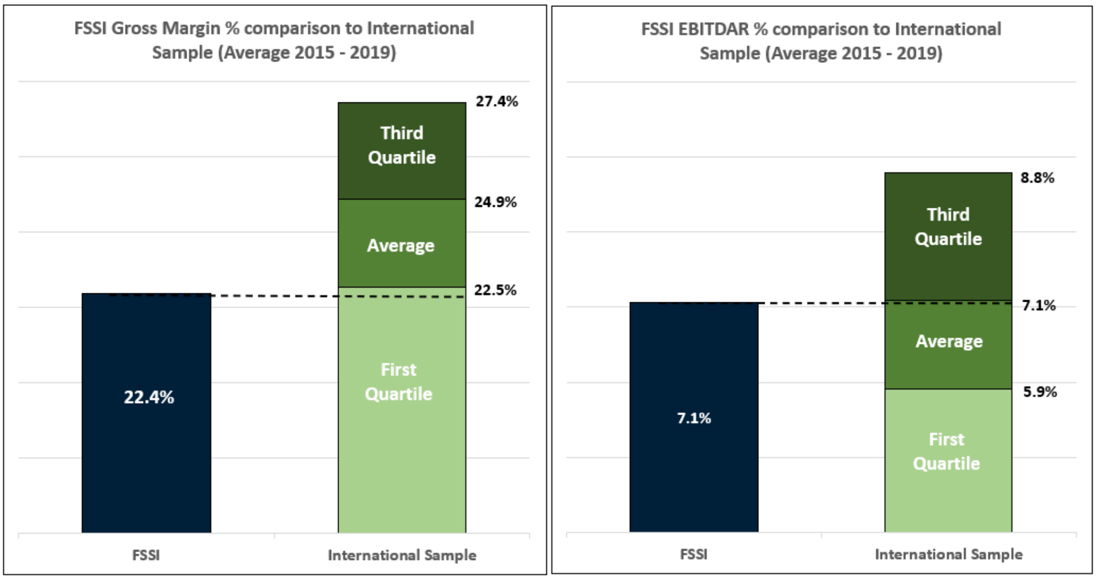


7 The method the Commission used, of artificially separating FSSI into retail stores and a cooperative to calculate FSSI's profitability, does not fully account for the cost of running a retail network.

8 More thoroughly analysed, FSSI's **Retail ROACE averages 8.5%** from 2015 to 2019. This return is:

- substantially less than the Commission's retail ROACE assessment of 23%; and
- below the ROACE for the international sample of grocery retailers of 11.3%.

9 When assessing profitability margins to achieve the most valid comparisons, EBITDAR and gross profit margin should be used. FSSI's profitability is consistent with overseas firms on this basis.



10 The Weighted Average Cost of Capital (WACC) is the benchmark that represents a normal (risk adjusted) rate of return on a capital investment. The Commission estimates a WACC of between 4.6% and 6.1% for the major grocery retailers and uses this to conclude that they are earning excess rates of return relative to WACC.

11 There are good reasons why FSSI's ROACE, and indeed the ROACE of the international sample, exceed the Commission's estimated WACC. This is because valuable intangible assets are not included in capital employed and therefore in the WACC calculation.

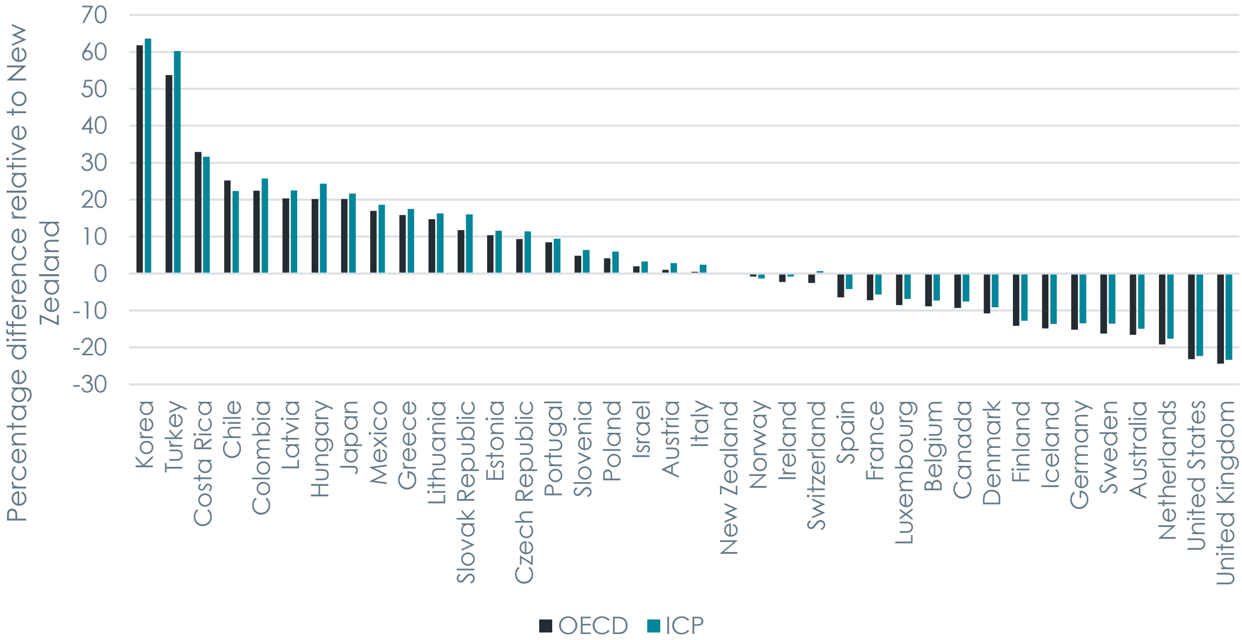
12 The inference from the Commission's draft report is that the major retailers' persistently high profits results in consumers paying a higher price than they should for their groceries. To provide context, if FSSI reduced its ROACE from 11.5% to the Commission's estimated WACC, then the cost of a $2 grocery item would reduce by 3 cents.

	FSSI ROACE - 11.50%	**NZCC WACC - 5.3%**	***Difference***
Retail Shelf Price	**2.00**	**1.97**	***(0.033)***
GST	0.26	0.26	*(0.004)*
Sales Price	1.74	1.71	*(0.029)*
Product Cost	1.34	1.34	-
Gross Profit	**0.39**	**0.3656**	***(0.029)***
Gross Profit %	*22.69%*	*21.38%*	
FSSI Expenses	0.33	0.33	-
FSSI Net Profit	**0.06**	**0.03**	***(0.029)***

International Grocery Price Comparisons

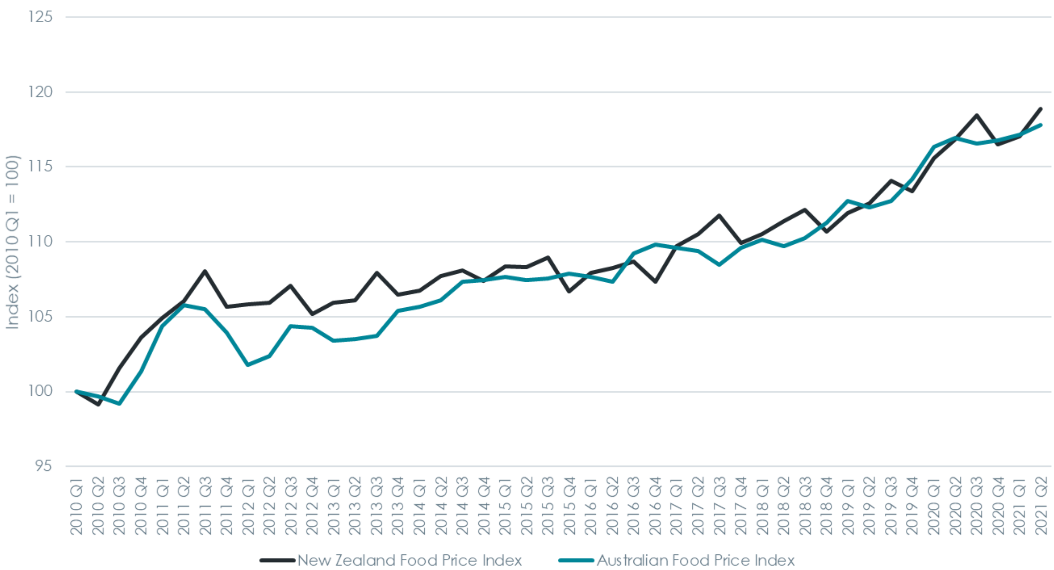
13 New Zealand grocery prices are not high by international standards and, in any event, say little on their own about retail competition.

14 Using the internationally accepted Purchasing Power Parity (PPP) mechanism (which the Commission has used in other areas) as opposed to market exchange rates as the Commission has done, New Zealand grocery prices fell in the middle of OECD countries in 2017.



15 If FSSI’s profits, as calculated by the Commission, were reduced to the Commission’s best estimate of WACC (5.3%), this would reduce grocery prices by only 2%. This would not affect New Zealand’s overall ranking in the OECD.

16 Furthermore, New Zealand’s grocery price inflation is consistent with Australia. While many factors may drive the differences in food prices between Australia and New Zealand, it does not appear that the number of grocery retailers, and particularly, the growth of a specific retailer, has had a significant effect on prices in either country.

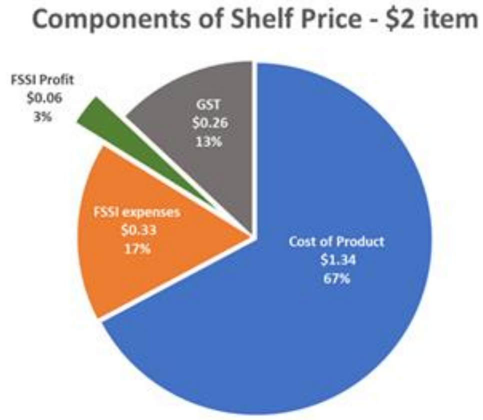


Innovation by grocery retailers

17 The Commission suggested that innovation by major grocery retailers is below that which could be expected given their draft findings on the major retailers' profitability. FSSI has invested, and continues to invest, in a variety of innovations which improved consumer shopping experiences and the resilience of FSSI's supply chain. This includes electronic shelf labelling, the roll out of online sales, Shop'nGo. FSSI has also introduced electric vehicle chargers, "Food in the Nude" and increased its distribution capacity which has provided consumers with a daily choice of fresh produce and added to FSSI's resilience during the COVID pandemic.

Supply cost of groceries

18 The cost price from suppliers makes up approximately **67 cents of every $1** for products on our supermarket shelves. The cost price from suppliers is the single biggest component in the price of groceries for consumers in New Zealand and this has not been fully investigated by the Commission as part of its market study.



Conditions of entry and expansion

19 FSSI's view is that entry to the retail grocery market is achievable and already happens. This is demonstrated by the imminent entry of big box retailer Costco to the New Zealand market and the emergence of numerous meal kit providers and online grocery sellers.

Supplier relationships

20 FSSI has strong relationships with its suppliers which are valuable and generally healthy. It places great value on its supplier relationships and the multi layered and meaningful relationships the Co-operative and its Members have developed with suppliers, some spanning many decades.

Improving Consumer Outcomes

21 FSSI notes the Commission's recommendations on consumer confusion and understanding of pricing and promotional methods of grocery retailers.

22 FSSI is open to reviewing its pricing and promotional methods at a retail level, and supports improving awareness and understanding with consumers of its instore promotions.

Access to products at the wholesale level

23 FSSI's view is that the wholesale supply of groceries in New Zealand is functioning well. The Commission's proposed changes to the wholesale grocery supply are untested and necessarily speculative. It is not proven that these changes would materially assist a third party retailer to operate in New Zealand.It is also far from clear that, even if other retailers did access existing wholesale supply, that this would provide any meaningful benefit to consumers.

24 Regulating access to a grocery wholesale market would be extremely complex due to the large and complex range of branded and differentiated products. In 2020, FSSI ranged 82,473 products across PAK'nSAVE, New World, Four Square and Trents.

25 FSSI operates a cross-subsidisation policy, which means that stores pay the same price for groceries irrespective of cost to transport goods to stores. The impact of cross-subsidisation (i.e. lower grocery prices in the regions than would be the case if all costs were attributed by store) needs to be carefully considered in the context of proposals for wholesale access and any proposed operational or structural separation (see below).

26 FSSI is a vertically integrated, intricately linked, single business and there is no clear wholesale retail distinction. This is not uncommon. Around the world, key grocery competition takes place on a vertically integrated basis, so there is also not an obvious model to copy. Effectively, any attempt to separate FSSI's business into wholesale and retail operations would mean it being fundamentally transformed, with associated cost and other implications for the individual co-operative members who own the stores.

27 There are a wide range of implementation challenges that the Commission, and industry, would need to consider and resolve.

Options to directly Improve Retail Competition

28 The Commission has noted the possibility of a Government sponsored new entrant in retail or divestiture of existing stores. As with our wholesale supply intervention comments above, a Government sponsored grocery retailer in New Zealand raises several issues and considerations that would need to be thoroughly assessed.

29 FSSI considers that any forced divesting of its stores is a drastic option without proven benefits for consumers. FSSI considers that this recommendation is not warranted. In particular, given that observable market outcomes (such as profitability) are consistent with workable competition, there can be no justification for requiring FSSI to divest parts of its retail operations.

Options to Improve Competition for the Acquisition of Grocery Products

30 FSSI is not opposed to a well-considered grocery code of conduct that deals with matters which are objectively unacceptable or outside commercial norms.