# FOODSTUFFS SOUTH ISLAND'S SUBMISSION ON GROCERY MARKET STUDY DRAFT REPORT

## INTRODUCTORY COMMENTS

1. Foodstuffs South Island (**FSSI**) acknowledges the importance of the Commerce Commission's market study into the retail grocery sector. As noted by the Commission FSSI has fully cooperated with the process to date, providing information, data and clarification as requested. It has also sought to collaborate with the Commission wherever possible.

2. FSSI has reviewed the Commission's draft report and this submission together with the appendices sets out its response to the matters raised in the draft report.

3. FSSI has sought to engage with the full spectrum of options for recommendations that the Commission identified in its draft report. Given the significance and complexity of many of the recommendations, and the time available to the Commission,[1] FSSI appreciates that their development is at an early stage. Where that is the case, FSSI has provided feedback and questions, with a view to assisting the Commission and/or Government to consider further the workability of the recommendations, and their potential to improve competition, ahead of the appropriate cost-benefit analysis and broader policy process.[2]

4. FSSI notes also that its own work is inevitably preliminary, given the short period it has had to consider and respond to the recommendations, (and from 18 August 2021 New Zealand had lockdowns in place, so FSSI's first priority was to meet its responsibilities to New Zealanders to keep staff and customers safe, and to deliver their grocery needs as an essential business).

5. By way of example, the recommendation option for FSSI to provide other retailers with access to its product and distribution network, referred to as its wholesale business by the Commission, raises a practical issue for FSSI as to how it might balance its current capacity with any incremental demand (the amount of which is, at this stage, unknown). It also potentially raises costs to consumers and risks agility and surety of supply chain. It has not been possible for FSSI to work through all of these sorts of issues in the time available – time and detailed consideration is required to progress this potential recommendation.

6. It should be noted there are a number of findings in the draft report that FSSI does not agree with, including that the Commission has materially overstated FSSI's profitability. It is important that the Commission has all necessary information so that its final report is robust. To that end, FSSI appreciates the opportunity to

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[1] Commerce Commission's Briefing for the Incoming Minister of Commerce and Consumer Affairs (November 2020) (emphasis added), "a study is a significant piece of work for the Commission – a detailed analysis of whether competition in a market is or is not working or could be enhanced. At the conclusion of a study the Commission may make recommendations to Government, business or consumers as to what could occur to make the relevant market work more competitively. Work of this nature requires a detailed evidence base and requires significant work from the sector involved"; MBIE's Briefing for the Incoming Minister of Commerce and Consumer Affairs (4 November 2020), "Our preliminary view is that **a supermarkets study will take approximately 16 months**."

[2] This is consistent with the Commission's view at [9.4] of the draft report (emphasis added): "When producing our draft report we have endeavoured to consider options that would most directly address the factors affecting competition that we have identified, are likely to improve competition, and are likely to be feasible. **These are the options for which we consider further investigation may be warranted. We acknowledge the importance of assessing whether the benefits exceed the costs of any recommended changes to the status quo**. However, cost-benefit analysis falls outside the scope of our study. Policy makers may undertake that analysis while developing or giving effect to any government decision about recommendations that it may wish to take forward after considering our final report."

provide further information to the Commission to improve the accuracy of its analysis.

7. FSSI proposes a number of changes to meaningfully improve customer value, and provide structure for suppliers and improvements to the competitive landscape:

   7.1 **encouraging competition and addressing barriers for new entry and expansion** by providing binding undertakings not to enforce existing restrictive land covenants and providing a commitment to not register future covenants when selling land. We would also encourage the Government to progress appropriate changes to the Resource Management Act and Overseas Investment Act regime to better encourage and facilitate new entry into the New Zealand market,

   7.2 **improving value and innovation outcomes for consumers**, by working together with suppliers and the Government to develop a consumer focussed grocery code to guide our dealings with suppliers and to protect their freedom to support other retailers,

   7.3 **delivering value for consumers by improving their ability to make informed purchasing decisions**, by:

      (a) simplifying and clarifying our pricing and promotional practices,

      (b) simplifying and clarifying our reward structures and loyalty terms and conditions, and ensuring we provide appropriate information in a straightforward way about our collection and use of data. This will enable consumers to better understand the value of these programmes, and

      (c) committing to consistent use of unit pricing, providing clarity on value to consumers.

8. While it has nevertheless engaged constructively with the full spectrum of options for recommendations, as noted above FSSI does not agree with certain of the key findings in the draft report. In short:

   8.1 FSSI's profitability is not excessive – it is normal. The Commission's profitability analysis did not recognise that FSSI is a fully integrated grocery retailing business. As a result, the Commission's estimate of FSSI's profitability was materially overstated:

      (a) FSSI, and its advisors, calculate its Return on Average Capital Employed (**ROACE**) to be approximately half what the Commission calculates it to be i.e. an average of 11.5% compared with the Commission's figure of close to 23%, and

      (b) correctly assessed FSSI earns a normal level of profit consistent with international grocery retailers. As such, it is unsurprising that there has been not more entry by offshore market participants,

   8.2 **workable competition exists in grocery markets in New Zealand**, and there is a range of evidence that supports that view, for example:

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

(b) FSSI has invested, and continues to invest in a variety of innovations which improve consumer shopping experiences and the resilience of FSSI's supply chain, and

(c) the Commission's consumer research demonstrates that consumer shopping behaviours have changed. In particular, consumer shopping behaviour is increasingly characterised by missions shopping i.e. smaller and more frequent shops in place of a main shop. Looking forward, it can be expected that the prominence of missions shopping will continue to grow. FSSI competes closely with all retailers for the full range of shopping missions, including for the size and scope of the "main shop", and

(d) relationships between FSSI and its suppliers are valuable and generally healthy and suppliers' behaviour reflects material bargaining power. The evidence FSSI presents on this point should not be read as FSSI failing to acknowledge any particular supplier that has experienced conduct which is potentially unlawful or falls outside acceptable commercial norms. As above, FSSI is supportive of a consumer focussed, well-considered grocery code. The focus of the code should be on outcomes for consumers, noting that for every $1 on the shelf, 67c comprises supplier cost.

9. The following submission and supporting documents set out:

9.1 FSSI's chapter by chapter response to the Commission's draft report (paragraph 14),

9.2 FSSI's response to the Commission's spectrum of options for recommendations (paragraph 330),

9.3 Incenta Consulting – Review of retail grocery services: Comment on the Commerce Commission's analysis of profitability, dated September 2021 (Appendix A),[3] and

9.4 HoustonKemp – Empirical evidence of grocery sector competition, dated 9 September 2020 (Appendix B)[4] and OECD price comparison analysis, dated 9 September 2020 (Appendix C).

**OVERVIEW OF SUBMISSION**

10. The Commission has concluded that competition in the retail grocery sector is not working well for consumers. As a result, the Commission has identified a spectrum of potential recommendations designed to improve competition. The Commission's overall conclusion has its foundations in four draft key evidential findings:

10.1 the major retailers earn excess profits, and these returns are persistent,

10.2 New Zealand grocery prices are higher than they should be,

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[3] FSSI provides confidential and open versions of this report.

[4] FSSI provides confidential and open versions of this report.

10.3 most consumers buy their groceries in a main shop, which the "fringe" of other retailers is unable to compete for, and

10.4 there is weak competition between the major retailers, especially on price.

11. Of these four draft findings, it is clear from the Commission's public statements, and the draft report, that the finding on profitability is at the core of the Commission's overall conclusion.

12. The Commission uses analysis it has conducted, and commissioned, to support each of its key evidential findings.

13. This submission will provide additional information and demonstrate that the analysis the Commission relies on does not support the key findings the Commission seeks to draw from it. Instead, the evidence and analysis demonstrates that the retail grocery sector is dynamic and competition is vigorous. In particular:

13.1 correctly calculated, FSSI's returns are broadly half of that calculated by the Commission. This level of return is consistent with the international sample of grocery retailers provided by the Commission,

13.2 proper analysis of the international price data demonstrates that New Zealand's grocery prices are not high by international standards, despite its location and population density. Rather, New Zealand prices fall in the mid-range of the OECD countries. In addition, by far the largest component (67%) of shelf price is the cost of the product paid to suppliers, which the Commission does not consider as part of the market study,

13.3 the consumer research establishes that modern consumer shopping behaviour is consistent with missions shopping, i.e. more frequent, smaller shopping trips, rather than a single "main shop", which is how consumers shopped in the past. For example, only 12% of participants in the Commission's consumer survey carried out one shop a week. As such, other shopping missions are the most accurate framework for a competition analysis and retail competition must be assessed across the full range of shopping missions. FSSI competes vigorously with other retailers to win these missions, and more generally, to win the largest part of a consumer's main shop, and

13.4 the promotions and pricing data analysis indicates that the major retailers compete intensely on price. The major retailers frequently use price promotions to win customers from each other. Further, the incomplete and inconsistent pass through of cost-changes demonstrates the dynamic and non-accommodating nature of price competition.

## MARKET CHARACTERISTICS AND SECTOR BACKGROUND

14. The nature and structure of the Foodstuffs Cooperatives has an important bearing in the calculation of profitability and the Commission's options for recommendations.

15. The Commission outlined in the draft report[5] how the Foodstuffs Cooperatives operate and notes the retail stores are separate owner operated franchises which

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[5] Draft report at [2.13]-[2.19].

are supported by the Cooperatives. In particular the Commission acknowledges that the Cooperatives own land and buildings used by many stores and the IT assets used by all the stores. It also acknowledges that other services are provided to the stores by the cooperatives including, product sourcing, ranging and promotional planning, retail execution support, marketing, IT and digital systems development, developing and renting properties for new retail stores, transactional shared services, HR and legal support.

16. FSSI would also add the Cooperatives provide training, manage the granting of franchises, provide brand positioning, format and pricing, promotions (with some overlay at stores), core ranging, ensure brand standards are maintained for the benefit of all members (and customers), IT services, food safety and loss prevention assistance.

17. The Cooperatives also take the lead in times of crisis, the COVID response being a good example, as well as FSSI's response to the Christchurch and Kaikoura earthquakes.

18. The retail stores are the beneficiaries of these services with their focus being on "execution" and the customer experience.

19. The assets of the Cooperative are held for the benefit of all member stores present and future. The FSSI Constitution provides that the retail stores:

> are the caretakers of the Cooperative and its assets. They have a responsibility to hand such assets on to enable future generations of independent grocers to trade cooperatively just as those that have gone before them have enabled them to trade.

20. It is our view that the degree of integration is such that the two parts cannot easily be separated. It makes little difference where the costs lie or the profits arise, because the ownership is 100% aligned and the stores as cooperative members receive the profit and meet the costs as the case may be.

21. However, and despite noting this high level of integration, the Commission has chosen in the draft report to attempt to separate out the "wholesale" part of the cooperative from the "retail" part for the purposes of calculating profit and when it comes to some of its recommendations. We believe this approach is artificial and does not reflect the reality of FSSI's business.

## MARKET OUTCOMES IN THE RETAIL GROCERY SECTOR

### Summary of FSSI's key points

22. FSSI considers that outcomes in the retail grocery sector are consistent with workable competition:

    22.1 *The Commission's calculation of FSSI's profitability materially overstates FSSI's profitability.* FSSI and its advisors calculate that its ROACE is approximately half of what the Commission has estimated. FSSI's analysis is supported by a report by Incenta Consulting, which demonstrates that correctly calculated, FSSI's profitability is similar to international grocery retailers on all measures (paragraph 24).

    22.2 *New Zealand's grocery prices are not high by international standards*, when compared using Purchasing Power Parity (PPP) exchange rates as is appropriate. Further, the Commission has overstated the effect of the *international price comparisons*. As the Commission acknowledges, it is not able to determine whether international differences in price are the result of different levels of competition, and analysis by HoustonKemp suggests that that is not the case (paragraph 102).

22.3 *FSSI has invested, and continues to invest, in a variety of innovations*. Given the smaller size of the New Zealand economy and population, it is inevitable that innovation will not progress at the same pace and scale as much larger countries, but that does not mean competition is not working well in the retail grocery market (paragraph 128).

23. In FSSI's view there is also vigorous competition in retail grocery markets on quality, range and service. This is reinforced by the Commission's later findings that other retailers compete with the major retailers on quality, range and service dimensions[6] and that the major retailers differentiate their retail grocery offering from each other, in part based on non-price factors.[7] However, FSSI does not discuss this finding further given the Commission has not been able to determine whether QRS offered to consumers differs materially from a workably competitive market, and that this is immaterial.

**The Commission has materially overstated FSSI's profitability**

24. FSSI appreciates that the Commission's conclusions on profitability are one of the most compelling pieces of evidence for its view that competition is not working effectively for the benefit of consumers.

25. The Commission's conclusions on profitability support many of the key findings made in the Draft Report. It is therefore important that the profitability analysis is completed with all necessary information, so that the outcome is robust.

26. On face value the Commission's analysis shows that FSSI makes returns of over 23% on its assets employed. FSSI does not consider that is an accurate reflection of its ROACE, which it has calculated as being in the range of 10.5% to 13.8%. This level of return is approximately half of the Commission's original calculation and is commensurate with the experience of overseas supermarkets. Therefore, FSSI considers that there is no evidence that its profitability is anything other than normal.

27. In this section of the submission, FSSI provides additional information to assist the Commission to improve the accuracy of its assessment. FSSI's key points are outlined broadly as follows:

27.1 *FSSI's ROACE should be calculated on a whole of business basis*. The Commission's methodology for calculating FSSI's ROACE sought to artificially separate the retail stores from the Co-operative and calculating ROACE for each. In reality, FSSI is a fully integrated grocery retailing business. Its profitability should instead be calculated on a "Whole of Business" basis – not the artificial separation of FSSI into retail and co-operative entities. Other major grocery retailers both in New Zealand and the Commission's international sample are fully integrated businesses, and so assessing FSSI's WOB profitability is an appropriate basis for making comparisons.

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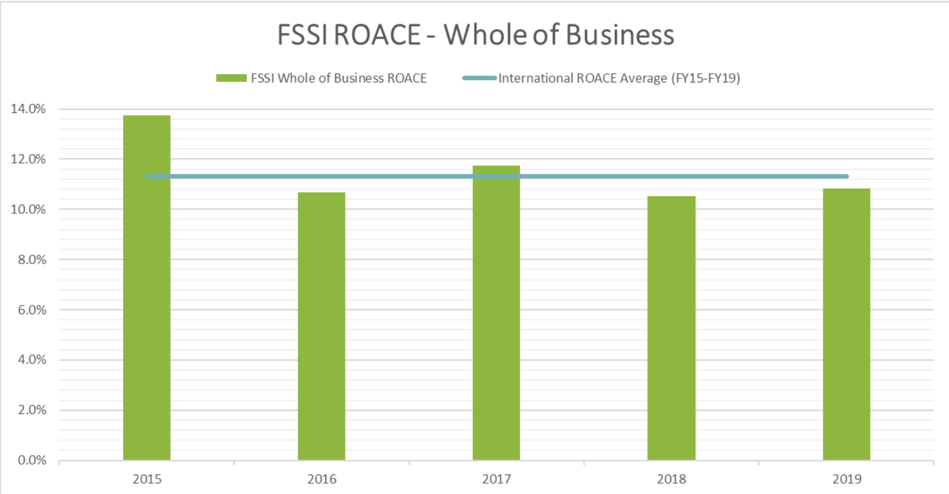
6 Draft report at [4.57].

7 Draft report at [5.110].

27.2 *A sample of international grocery retailers is the best profitability comparator for New Zealand grocery retailers*. The international grocery retailer average can be considered representative of normal returns for grocery retailers, because those retailers are engaged in the same business as FSSI, and can be expected to have normal levels of economic profitability to the extent that they operate in competitive markets. The Commission would need to find that FSSI's profitability is "significantly" above the level of these normal returns, and persistently so, before it could infer a lack of workable competition.[8] Such evidence is not available here. There is therefore no basis for concluding that FSSI's profits are anything other than normal. The outcome of this test suggests that the New Zealand grocery retail market is operating as a competitive market.

27.3 *FSSI's profitability, calculated on a Whole of Business basis, is normal*. FSSI's ROACE, calculated on a whole of business basis, and correcting for other errors made by the Commission, is an average of 11.50% over a five-year period (2015-2019).[9] This is approximately half of the ROACE the Commission calculated for the FSSI Retail stores of close to 23% and is consistent with the ROACE of the international grocery retailers (calculated by the Commission as 11.32% over the same period). This is shown graphically below.




27.4 *FSSI's profitability, assessed on a whole of business or retail only basis, is consistent with the Commission's sample of international grocery retailers*. The Commission has assessed the ROACE of a set of international grocery retailers at 11.32%. FSSI's ROACE, assessed on either methodology, is either consistent with, or below, the return of its international counterparts.

27.5 *FSSI's profit margins are also consistent with the Commission's sample of international grocery retailers.* Making the corrections identified above also materially changes FSSI's profit margins. Correctly assessed, FSSI's whole of business profit margins, assessed on Gross Profit margin and EBITDAR[10] margin, are consistent with international grocery retailers.

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[8] Incenta Consulting report at [92].

[9] FSSI presents its calculations of its profitability based on an average over 5 years (2015-2019). This is the same time period that the Commission used to assess profitability.

[10] Earnings before interest, tax, depreciation, amortisation and rent.

27.6 *FSSI's profitability, calculated on an artificial retail only basis, is normal*. If, despite the information FSSI presents for a whole of business analysis, the Commission was to persist with its artificial separation of FSSI's business into Retail and Co-operative, then certain changes need to be made to its methodology and calculations. In particular, the Commission's methodology needs to be amended to treat the retail stores as owning the land and buildings of the stores. Various errors in the Commission's sensitivity analysis also need to be corrected. If these changes are made, FSSI's Retail ROACE is approximately 8.50%. This is less than half of the 23% return that the Commission originally calculated. It is also lower than the 11.32% ROACE of the international comparators calculated by the Commission.

28. The Commission's view that profitability is an indicator of a lack of competition is flawed. For completeness, FSSI notes that its profit makes up a very small portion of the shelf price consumers pay for a grocery item (approximately 3%, or for a notional $2 grocery item, 6 cents). By comparison, 80% of the shelf price is comprised of supplier product cost and GST. As such, FSSI's analysis indicates that a significant reduction in ROACE would result in only a very small reduction in shelf prices. For example, if FSSI's ROACE was halved, this would result in a 1.9% decrease in shelf prices, or a 3c decrease in price for a $2 grocery item.

***FSSIs profitability should be assessed on a whole of business basis***

29. The Commission has chosen to treat FSSI as separable Co-operative and Retail business entities. However, FSSI operates as a single integrated business and the Co-operative and retail operations are not easily separated for analysis as distinct standalone entities.

30. To justify this treatment the Commission explains:[11]

> Our profitability assessment... has focussed on the owner-operated retail stores because they directly engage in grocery retailing. By contrast, the co-operatives are serve providers to the grocery retailers, including wholesale purchasing, warehousing and distribution of groceries, and administration and coordination of operations for which they receive payment from the retail stores.

31. This is not the way that FSSI operates its business. FSSI is a single integrated operation, and the Co-operative plays <u>the</u> central role in that business. The suggestion that the Co-operative is simply a wholesale service provider to the retail stores significantly understates that role. The stores could not exist without the Co-operative – the Co-operative is the "heart, lungs and brain", and the stores are the "arms and legs" simply delivering the retail execution. In particular:

31.1 the Co-operative makes the key decisions relating to how Foodstuffs competes day to day, including being responsible for:

(a) brand positioning, format and pricing (with some overlay at stores),

(b) product ranging,

(c) promotions (with some overlay at stores),

(d) digital innovation,

[11] Draft report at [3.25].

(e) marketing,

(f) provision of supply chain infrastructure, including warehousing, inventory management, distribution and transportation, and

(g) other critical function support across Human Resources, Finance, Legal and IT,

31.2 the Co-operative makes the key decisions relating to how Foodstuffs competes in the long term, including being responsible for:

(a) operator selection and training,

(b) selecting the sites for new retail stores, and

(c) property network strategy (including the acquisition of land for future stores) and store design, and

31.3 the Co-operative owns the IT infrastructure that the stores need to operate and manage their stock.

32. These are not the kinds of activities that an ordinary wholesaler would carry out. It also demonstrates that the Commission was quite wrong to characterise the co-operative as "more like a property company than a company involved in grocery retailing".[12]

33. The retail stores operate within that wider framework and execute the decisions made by the Co-operative. As a result, there is a very high degree of integration between the Co-operative and the retail stores. Put another way, the retail stores simply could not function without the Co-operative.

34. The high degree of integration between the Co-operative and the retail stores makes it is very difficult to split the business into two and assess each part separately. In seeking to do so the Commission has simply added the financial accounts of each store together, and then made a rent adjustment to create an artificial retail supermarket entity to arrive at its conclusions.

35. FSSI considers that, instead, its ROACE should be assessed on a whole of business basis. This is consistent with the Commission's stated intention to test the profitability of FSSI as a whole. For example, the Commission notes (emphasis added):[13]

> Therefore, in spite of the relationship between the co-operative and its member stores making it difficult to estimate the stand-alone ROACE profitability of the retail stores, it appears that **overall the** Foodstuffs NI and **Foodstuffs SI networks** (**ie, the combination of the co-operative companies and their owner-operated stores**) are making excess profits relative to their WACC...

36. This avoids the difficulties inherent in separating the business into two. Further:

36.1 it reflects the actual operations of FSSI as a single integrated operation,

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[12] Draft report at [C188.2].

[13] Draft report at [3.50].

36.2 it avoids the need to make subjective estimations and assumptions about the transfers that occur between the Co-operative and the retail stores. Such transfers will inevitably involve an element of guesswork. As such, Incenta Consulting concludes that calculating returns on a whole of business basis would be "substantially more meaningful and reliable"[14],

36.3 it is consistent with the Commission's assessment of Woolworth's ROACE, which was to assess the whole company, excluding non-grocery subsidiaries,[15] and

36.4 it is consistent with the Commission's international sample, most of which are fully integrated businesses,[16] rather than being independent retail businesses without warehousing and distribution assets and capability.

37. This demonstrates that there is artificiality in the Commission's analysis. The Commission appears to consider that the functions performed by the FSSI Co-operative are sufficiently separate to grocery retailing and therefore should not be considered in the assessment of the retail stores' profitability. Yet the same functions of the Co-operative are performed within Woolworths' business and have been factored into the assessment of its profitability. The fact that FSSI has chosen to structure its business differently than Woolworths does not mean that its profitability should be assessed in such a different way.

38. FSSI sets out the detail of its whole of business below, including the adjustments that FSSI has made to the Commission's assessment of Retail and Co-operative ROACE, and the further adjustment it has made for the market value of assets.

***Calculating FSSI's whole of business ROACE***

39. FSSI has made the following corrections to the Commission's calculations in respect of the retail stores and the Co-operative, in order to calculate its whole of business ROACE:

39.1 In respect of the retail stores, FSSI has:

(a) Adjusted for the current portion of a store's interest-bearing borrowing. These were included in overall Current Liabilities in the initial data provided to the Commission but should be excluded from capital employed.

(b) Removed one-off gains derived from the sale of a store during the financial year that are unrelated to the trading operations of a retail supermarket. These are predominantly the gain on sale of plant, machinery and furniture & fittings in the selling store's accounts.

40. Having made these adjustments, FSSI has consolidated the Retail and Co-operative parts of its business, to produce a whole of business ROACE that averages 11.50% over the five-year period of 2015-2019.

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[14] Incenta Consulting report at [30].

[15] Draft report at [3.23].

[16] Incenta Consulting report at [30c].

*Adjustment for market value of assets*

41. FSSI's assets are included in the financial statements at book value. This significantly understates the economic value of the land and buildings. The value of these assets needs to be uplifted to market value. The Commission has made a similar adjustment for Woolworths' land and buildings.[17]

42. In order to allow for the land and buildings at market value, FSSI provided the Commission with valuations completed for its properties over the last 1-3 years. FSSI considers that overall the market values are, to some extent, conservative as some of the valuations are up to 3 years old.

43 Allowing for FSSI's land and buildings at a five-year average market value results in a [ ] uplift on book value.

44 FSSI has then allowed for an estimated gain on revaluation. It is, for a variety of reasons, difficult to form a precise view on the likely magnitude of anticipated revaluation gains.[18]

45 The purpose of allowing for a gain on revaluation is to recognise the gain that a potential new entrant retailer reasonably would have anticipated and would reasonably expect in the future. This is the level of gain that a retailer could:[19]

45.1 reasonably have factored into its past pricing, and

45.2 could expect for the purposes of calculating future profits, and therefore, for the purpose of making investment decisions.

46 As Incenta Consulting explains, large positive gains may have occurred in past years and equally large revaluation losses may have occurred in other years. This reflects that property prices tend to be unpredictable in the short term. However, if those returns are factored into an assessment of profitability, then the calculation may show large profits or losses, even though those outcomes were entirely unexpected by the parties and could not have influenced how the party behaved.[20]

47 Against that background, FSSI has allowed for the estimated gain on revaluation by assuming an annual [ ] gain on estimated opening market value. The [ ] gain is a long-run forward-looking assumption, which is consistent with Incenta Consulting's recommendation. Incenta recommends applying the long-term forecast of CPI growth as a proxy for the expected rate of revaluation gain from land and building assets, and adopting an assumption of [ ] which is [ ].[21]

48. As noted, the assessment of the market value of FSSI's assets is conservative. If a current market value were to be used, FSSI's Capital Employed would increase significantly, with a corresponding reduction in ROACE.

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17 Draft report at [C135].

18 Incenta Consulting report at [56(a)-(d)].

19 Incenta Consulting report at [55].

20 Incenta Consulting report at [55].

21 Incenta Consulting report at [58].

### *A sample of international grocery retailers is the best profitability comparator for New Zealand grocery retailers*

*Comparisons to international grocery retailers are appropriate*

49. FSSI's ROACE on a whole of business basis is 11.50%. This is entirely consistent with the ROACE of the international sample of grocery retailers, which is 11.32% as presented by the Commission. This analysis demonstrates that FSSI has earned a normal level of profit over the past five years.

50. The Commission notes in the draft report that comparing FSSI's ROACE against a sample of international grocery retailers provides an indication of the relative levels of profitability between New Zealand and other jurisdictions, which will have normal levels of economic profitability to the extent that they operate in competitive markets.[22]

51. FSSI agrees that the ROACE of the international sample of grocery retailers provides the most robust benchmark for a "normal" return. These retailers are engaged in the same business as FSSI and therefore provide other real-world assessments of the return that can be expected. Furthermore, there are companies in the comparator set operating in markets where there are many more grocery retailers, such as the United Kingdom and the United States. This approach is to be preferred to comparisons to the NZX50 companies and theoretical assessments of an appropriate return, which are inevitably prone to estimation and error.

52. The fact that FSSI's returns are comparable with the international sample of grocery retailers may also explain why there has not been significant recent entry by overseas retailers. That is, there is little incentive for such retailers to enter the New Zealand market, if the returns they could expect to make are less than overseas.

53 In the following sections, FSSI makes three further points regarding comparisons to test the appropriateness of its ROACE, which are explained in more detail in Incenta Consulting's report:

  53.1 seeking to benchmark ROACE against WACC is prone to error,

  53.2 seeking to benchmark FSSI's ROACE against the ROACE of the NZX50 companies is not appropriate, and

  53.3 various corrections to the international sample reinforce that FSSI's profitability is consistent with that sample.

*Comparisons to WACC are not appropriate*

54 The Commission considers that WACC is the most appropriate benchmark.[23] The Commission determines an estimated WACC range of 4.6% to 6.1%.[24] As above, FSSI considers that comparisons to other real world examples, namely the international sample, rather than a theoretical and estimated WACC, is the most appropriate benchmark.

55 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

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[22] Draft report at [C78.2].

[23] Draft report at [C78.1].

[24] Draft report at [3.36].

valuable intangible assets are not included in capital employed and therefore WACC. In particular, as explained in the Incenta Consulting report at [69]:

55.1 A critical assumption when benchmarking to WACC is that the capital employed used for the calculation of ROACE is a comprehensive accounting of the economic assets that are required to undertake grocery retailing (and that a new entrant into this activity would need to replicate). However, there is substantial evidence that a material share of the assets that firms create over time – and especially in sectors like grocery retailing where internal know-how is a key source of competitive advantage – is simply excluded from any measure of capital employed that is based on accounting data.

55.2 Thus, unless an allowance is made when calculating ROACE for FSSI to reflect these unbooked intangible assets, then even if the market within which the firm operated was vigorously competitive, a return that is systematically above WACC would be expected, to reflect the return that would be permitted for the unbooked intangible assets. If a comparison is made against the WACC, this return on unbooked assets would be incorrectly interpreted as an excess return.

55.3 This concern is much reduced, however, if the returns for the entity being assessed is compared against the returns of international grocery retailers. This is because the returns of the firm being assessed and the benchmark against which it is being compared would both be expected to contain a similar upward bias, thus providing for a more appropriate comparison.

56 Incenta Consulting also notes that, if benchmarking to WACC, a decision needs to be made about the correct WACC to apply.[25] This is not straightforward. For example, the Commission has used current interest rates in its calculations of WACC. However, the returns observed today are the product of investment decisions made decades ago, at which point interest rates were significantly higher (at least double today's rates). As another example, a new entrant would be expected to factor in its expectations about interest rates over the life of its investment (i.e. a decade or more). A new entrant would be unlikely, in that context, to assume that the current very low interest rates would continue for that period.

*Comparisons to NZX50 companies are not appropriate*

57 The Commission has sought to compare FSSI's ROACE to the ROACE of the NZX50 companies, excluding banks. The Commission considers this allows it to determine how well grocery retailers are performing relative to a basket of large-scale companies operating in the same economy.[26] The Commission calculates that the weighted average ROACE of these companies is 6.4%.

58 However, as set out in the Incenta Consulting report caution is needed when comparing to this subset of the NZX50. The NZX50 companies operate across a wide range of different industries. The Commission has not established that there is any comparability between the activities of the NZX50 companies and FSSI.[27] In many cases, it is apparent that there is no comparability in business activities. As

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[25] Incenta Consulting report at [69].

[26] Draft report at [C78.3].

[27] Incenta Consulting report at [72].

such, it is not clear why comparisons to the NZX50 companies are relevant, or meaningful.

59 Further, there is significant variation in the realised ROACEs across the NZX50 companies, depending on industry sector, and even then between firms within sectors, ranging from -146% for Pushpay Holdings Ltd to 43.7% for The a2 Milk Co Ltd.[28] As such, the average ROACE of this subset of firms will differ significantly depending on how it is calculated. For example, the Commission calculated an average ROACE of 6.4% by weighting the firms by capital employed. If it had instead calculated a simple average, as it did with the international sample of retailers, the average ROACE would be 2.4%.[29]

60 In calculating the average ROACE, the Commission applied more than 50% weighting to Fonterra and low risk utility and infrastructure firms, such as Chorus and Vector.[30] Many of these firms are regulated and so would be expected to have relatively low ROACEs. The Commission also applied a 5% weighting to Auckland Airport, which is another regulated business.[31] This further reduces the meaningfulness of the comparison between these companies and FSSI.

61 Finally, FSSI's ROACE of 11.50% is comparable to the average ROACE for NZX50 firms that operate in sectors with a closer relationship to FSSI's activities and operations. For example, Incenta calculates the simple average ROACE for comparable sectors as follows:[32]

61.1 consumer discretionary products (e.g. Restaurant Brands New Zealand Ltd) – 13.6%,

61.2 consumer stable products (e.g. Sanford) – 12.4%, once Fonterra and a2 Milk are excluded,[33]

61.3 industrial services (transport) (e.g. Mainfreight Ltd) – 11.5%, and

61.4 real estate (e.g. Precinct Properties New Zealand Ltd) – 9.3%.

*Corrections to the international sample*

62. Incenta Consulting has made various corrections to errors in the Commission's international sample. Some of the corrections that have been made relate to:

62.1 The three UK companies included in the analysis do not report profit and loss categorisations of Cost of Goods Sold (**COGS**) and operating expenses consistently with all other companies in the international comparison. This materially understates the gross profit of the three UK companies (see Incenta Consulting report at [97]).

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28 Incenta Consulting report at [73] and Table 9.

29 Incenta Consulting report at [73].

30 Incenta Consulting report at [75] and Table 9.

31 Incenta Consulting report, Table 9.

32 Incenta Consulting report at [76].

33 As explained by Incenta Consulting, Fonterra is more appropriately classified as an infrastructure firm given the regulated nature of its operations. The exclusion of a2 milk is conservative, given its average ROACE was 43.7% (see footnote 41 of the Incenta Consulting report).

62.2 Two French companies that are included in international sample are in effect the same company, and therefore have been double counted in the Commissions ROACE calculations. Those companies are Casino Guichard Parrachon SA and Rallye SA – Rallye SA is the holding company that owns Casino Guichard Parrachon SA (see Incenta Consulting report at [96]).

62.3 Three companies have been included in the international sample that have a negative Capital Employed. Therefore, these companies' ROACEs used in the Commissions analysis are unstable and should not be used to produce a meaningful comparison to FSSI profitability (see Incenta Consulting report at [97]).

63. To allow for a fairer comparison to FSSI, Incenta has also made various adjustments to the international sample. Incenta's analysis demonstrates that FSSI's ROACE remains consistent with that of the international sample after these adjustments are made. In particular:

63.1 Benchmarking for cash: the Commission has retained cash as part of Capital Employed. However, a number of non-Western firms in the international sample hold excessive cash balances, likely reflecting less developed financial markets. These cash balances affect ROACE.[34] Incenta proposes two adjustments to correct for this issue – either removing cash or using a normalised level of cash.[35] Incenta's analysis demonstrates that FSSI's ROACE remains consistent with the international sample on both measures:[36]

(a) with a normalised amount of cash included in Capital Employed, FSSI's ROACE is 9.7%, compared to the international sample ROACE of 9.2%, and

(b) with cash removed from Capital Employed, FSSI's ROACE is 10.3% compared to the international sample ROACE of 9.6%.

63.2 Adjusting for the extent of ownership vs renting: As explained above, it is essential that, when comparing FSSI to the international sample, a similar level of ownership is assumed. If FSSI's ROACE is to be calculated consistent with the reality that it owns most of its assets, then the international sample will need to be adjusted to reflect a similar level of ownership. The international sample owns approximately 66% of its assets, which needs to be adjusted to 100% ownership. Incenta calculates that the average ROACE of the international sample would decrease to 9.2% over 2015-2019 if this adjustment is made.[37] This is consistent with FSSI's ROACE of 11.5%.

63.3 By extension, if the Commission was to pursue a renter assumption, then the international sample will need to be adjusted to reflect a lower level of ownership (a decrease from 66% ownership to 30% ownership). Incenta calculates that the average ROACE of the international sample would increase to 21.8%.[38] For reasons explained, FSSI has not presented a calculation of its

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[34] Incenta Consulting report at [100]-[102].

[35] Incenta Consulting report at [103].

[36] Incenta Consulting Report, Table 5 and Table 8.

[37] Incenta Consulting report, [116].

[38] Incenta Consulting report at [116].

ROACE adopting a renter assumption. FSSI notes that a ROACE of 21.8% is broadly consistent with the Commission's calculation of FSSI's Retail ROACE of 22.6%. Although, as explained above, there are a number of corrections that would need to be made to improve the accuracy of that calculation.

64. Incenta's analysis demonstrates that with FSSI's ROACE remains consistent with that of the international sample after these corrections.

***FSSI's profitability margins are consistent with the international sample and corroborate the findings on ROACE***

65. The Commission has also utilised various profitability margins to assess FSSI's profitability. With regard to the use and comparison of these margins FSSI considers that the margins should be:

65.1 calculated on a whole of business basis – this addresses the Commission's concern that margins for stores may be distorted by intra-cooperative transactions,

65.2 calculated in a manner that is neutral as to whether assets are owned or rented, and

65.3 independent of how firms choose to finance (i.e., level of traditional debt finance)

66. As explained in more detail in the Incenta Consulting report, to achieve a useful and valid comparison, the most relevant margins are EBITDAR (earnings before interest, depreciation, and rent) under IFRS 16 and gross profit margin (see Incenta Consulting report at [85]-[86]). The Commission has also used EBIT and NPAT margins, FSSI considers these are not appropriate measures for comparison:

66.1 EBIT margin is affected by decision of rent vs own, and deriving clear benchmarks with comparison companies is problematic, and

66.2 NPAT margin is affected by level of (traditional debt) financing, in addition to the rent vs own distortion.

67 FSSI's gross profit and EBITDAR margins, correctly calculated, are consistent with the international sample.[39] In particular, Incenta Consulting reports that:[40]

67.1 FSSI's gross profit margin of approximately 22.4% is below the average of 24.9%. It is also less than the first quartile observed for the international comparators (22.5%), indicating that three quarters of the international comparators have higher GP margins, and

67.2 FSSI's EBITDAR margin is 7.1% which is in-line with the average in the international sample.

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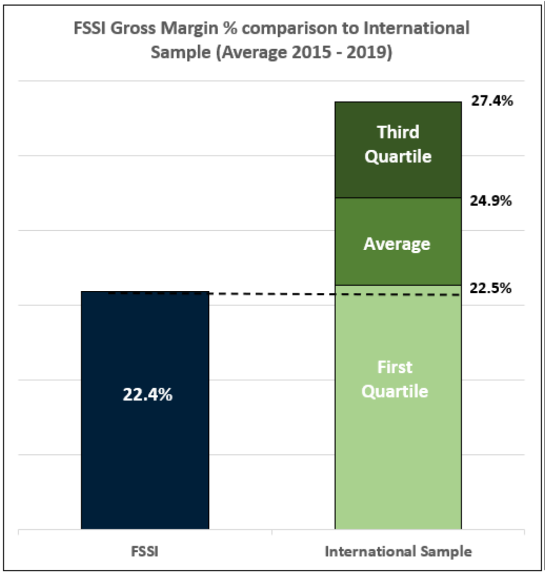
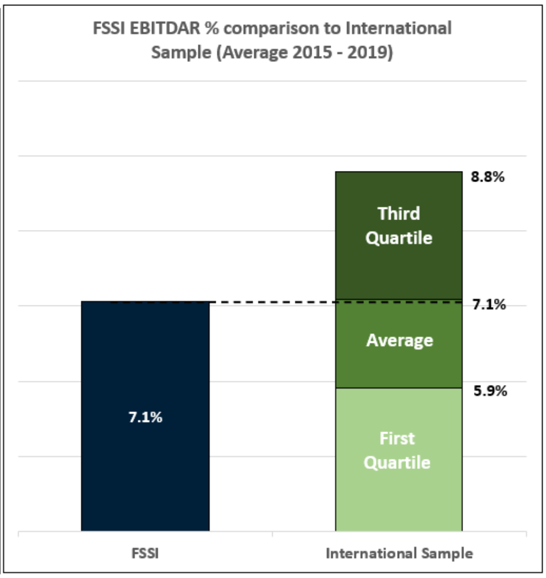
[39] Incenta Consulting report, Table 8.

[40] Incenta Consulting report at [139] and Table 7.




***Calculating FSSI's ROACE by using the Commission's approach of artificially separating the retail stores and the Co-operative***

68. For the reasons explained above, FSSI's profitability ought to be assessed on a whole of business basis. However, the purpose of this section of the submission is to demonstrate that even if the Commission's flawed approach of artificially separating the retail stores and co-operative is adopted, FSSI's Retail ROACE is 8.5%.

69. FSSI has made a number of corrections to the Commission's Retail and Co-operative ROACE calculations, including its adjustments to transfers between the Retail Stores and the Co-operative, to reach this result. These corrections are set out in more detail below.

*Adjustment One: Removal of the retail stores capital investment in FSSI*

70. The retail members' capital investment in FSSI (Retained Patronage shares and Trading Deposit shares) is removed from Capital Employed, and the related income is removed from the members NPAT. These are removed as they are FSSI funding mechanisms associated with being a FSSI member and not related to retail trading.

*Adjustment Two: Amendment of Wholesale margin to reflect the correct level of Co-operative assets*

71. The Commission sought to adjust retail profits to recognise a recovery for the capital cost of the Cooperatives assets (described in C181–182 in the draft report). The Commission attempted to do this analysis, but omitted significant assets owned by the Co-operative which are used to support the retail stores.

72. To correct for this, the Commission purported to determine the value of the Co-operative's fixed assets and applied a WACC margin to determine a notional annual capital cost that should be recovered by the Co-operative from the retail stores. FSSI has made a number of corrections to this analysis. In particular, FSSI has:

   72.1 included the Distribution Centre and Office Land & Buildings and IT Software when determining the Co-operative's assets base. All of these assets are required for the stores to successfully carry out grocery retailing and therefore should be included. However, the Commission's calculation only included Plant, Equipment, Fittings and Vehicles. As a result, it materially understated the Co-operative's fixed assets, and

72.2 applied a post-tax WACC margin of 6.1% over this adjusted perimeter. The Commission in its calculation applied tax on the post-tax WACC return which is double counted in error.

*Adjustment Three: Allocation of retail assets at book value*

73. The FSSI Co-operative owns the land and building assets used for grocery retailing and the retail stores pay the Co-operative a fixed percentage of turnover to rent these assets from the Co-operative. As set out in C179–180 of the draft report, the Commission concluded that the rent paid by the retail stores was below market rents. The Commission sought to adjust for this by increasing the retail store rental payments.

74. FSSI considers that, instead, its retail stores should be treated as owning the land and buildings used by those stores. This reflects the reality that FSSI owns the retail land and buildings, but has chosen to structure its business in a way that means these assets are held at Co-operative, not store, level. To treat the retail stores as renting their retail assets has the effect of treating FSSI as if it has a leased ownership model, which it plainly does not.

75. This approach also removes the need to test the Retail Store's rent payments. The Commission recognised that allocating the retail assets to the retail stores was an alternative approach to testing the rental payments, but considered this would require more adjustments and there would be a greater risk of getting those adjustments wrong.[41] In fact, with the correct information, it is relatively straightforward to allocate the retail assets to the retail stores, along with the required adjustment to the property related costs. All of these amounts are known and quantified. By comparison, it is much more difficult, and more prone to guesswork and inaccuracy, to estimate a market rent.

76. Accordingly, FSSI has adjusted the Commission's calculations by allocating the land and buildings related to retail stores at book value and adjusted for the property related costs on retail land and buildings to reflect the property ownership model.

77. FSSI refers to the report prepared by Incenta Consulting, which notes the significance of this issue (see section 2.2.2 of report). Incenta Consulting explains that whether a firm is treated as a renter or owner of the assets it employs has a material effect on the return on capital that is measured for the firm (i.e. under pre-IFRS 16 accounting standards) and that the firm requires.[42] The decision of whether to rent an asset or own an asset is a financing decision, and an alternative way to standard debt financing to participate in an activity with less equity finance. For example, a firm wanting to commence a retail grocery operation without contributing material equity finance could:

77.1 rent its land or buildings under a long-term lease, or

77.2 purchase and own its land and buildings, and wholly debt finance this purchase.

78. Both of these outcomes are essentially identical, as they require that part of the firm's cash flow first needs to be devoted to a material fixed commitment (i.e. rent or interest payments). However, in the Commission's calculations, only the effect of

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41 Draft report, footnote 998.

42 Incenta Consulting report at [25].

traditional debt finance on required returns has been recognised – the effect on leverage of leased assets has been ignored. The effect of this can be seen in Table 2 in the Incenta Consulting report, which shows that a firm that rents its assets will (under pre-IFRS 16 accounting standards) have a materially higher return than a firm that owns its assets.

79. The new accounting standard, IFRS 16, seeks to correct this issue. It requires recognition of both the interest cost and asset and liability implications of renting. As such, it brings accounting methods into closer alignment with true economic costs and values. This effect can also readily be observed from Table 2 of Incenta Consulting's report, which shows that a firm that rents its assets will under IFRS 16 make the same return as a firm that owns its assets.

80. The Commission chose not to apply IFRS 16 in its calculations of ROACE because:

80.1 IFRS 16 only came into effect in 2020, and the Commission was studying FSSI's profitability over 2015-2019.[43] But IFRS 16 was introduced to improve financial reporting. There is no reason why it should not be applied in the Commission's calculations and it is straightforward to do so,

80.2 IFRS 16 represented a change only to accounting standards. However, IFRS 16 seeks to improve the economic meaning of financial accounts. Adopting IFRS 16 is therefore consistent with the Commission's stated intention of assessing the "economic value of the assets",[44] and

80.3 The value of the lease asset will be closely matched by the value of the liability, such that the two tend to cancel each other out.[45] However, the analysis in Incenta Consulting's report demonstrates that there is a significant effect on ROACE depending on whether IFRS 16 is adopted.[46]

81. In addition, the Commission has adopted IFRS 16 in its input methodologies.[47]

82. The Incenta Consulting report also makes important points as to why the retail stores should be treated as asset owners. In summary, treating the stores as asset owners:

82.1 is consistent with reality, since FSSI owns the vast majority of land and building assets it employs for grocery retailing. No compelling economic reason exists to justify adopting a hypothetical assumption that FSSI rents its assets (see Incenta Consulting report at [39(a)], and

82.2 from an economic perspective ensures that:

(a) the broadest possible scope of economic assets that are employed to undertake grocery retailing are included in the calculated "capital

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43 Draft report at [C76.3].

44 Draft report at [C76.1].

45 Draft report at [C76.2].

46 Incenta Consulting report, table 2.

47 See generally https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases

employed". This results in a better measure of the economic returns from the activity (see Incenta Consulting report at [39(b)]), and

(b) the measurement of returns is independent to the maximum extent possible from how firms choose to finance their activities, which is a desirable objective and consistent with the Commission's long-standing good practice of ignoring financing decisions when assessing or calculating returns (see Incenta Consulting report at [39(c)].

83. Finally, Incenta Consulting notes that the degree of asset ownership needs to be considered when benchmarking FSSI against the international sample of grocery retailers. The Commission has calculated FSSI's Retail ROACE on the basis that approximately 70% of its assets are leased,[48] and then compared it to an international sample that owns approximately 66% of its assets.[49] This is not a meaningful – or fair – comparison.[50] As explained above, returns for highly levered businesses will be significantly higher than returns for businesses that own most of their assets. As such, the international sample needs to be adjusted to reflect the extent of FSSI's asset ownership.[51] This will result in a corresponding adjustment average ROACE of the international sample:[52]

83.1 if an owner assumption is applied, then the average ROACE will decrease slightly, on the basis that the Commission's current calculation assumes the international sample owns the majority, but not all, of its assets (66% ownership), or

83.2 if a renter assumption is applied, then the average ROACE will increase significantly, reflecting that the Commission has calculated ROACE assuming the international sample rents only 30% of its assets.

*Adjustment Four: estimated market value*

84. Given that FSSI has treated the retail stores as asset owners, a consequential adjustment is required to uplift the retail assets from book value to market value. FSSI has:

84.1 adopted the market values explained above (in paragraphs 41-43 ) in the context of the WOB analysis,

84.2 consistent with the WOB analysis, applied an estimated gain on revaluation assuming [ ] gain on estimated opening market value (see paragraph 44-47), and

84.3 applied the associated market value adjustment to Capital Employed.

85. The impact of these four adjustments is a total decrease in Retail ROACE of 14.1%, to a total FSSI retail ROACE of 8.5%.

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48 Incenta Consulting report at [106].

49 Incenta Consulting report at [106].

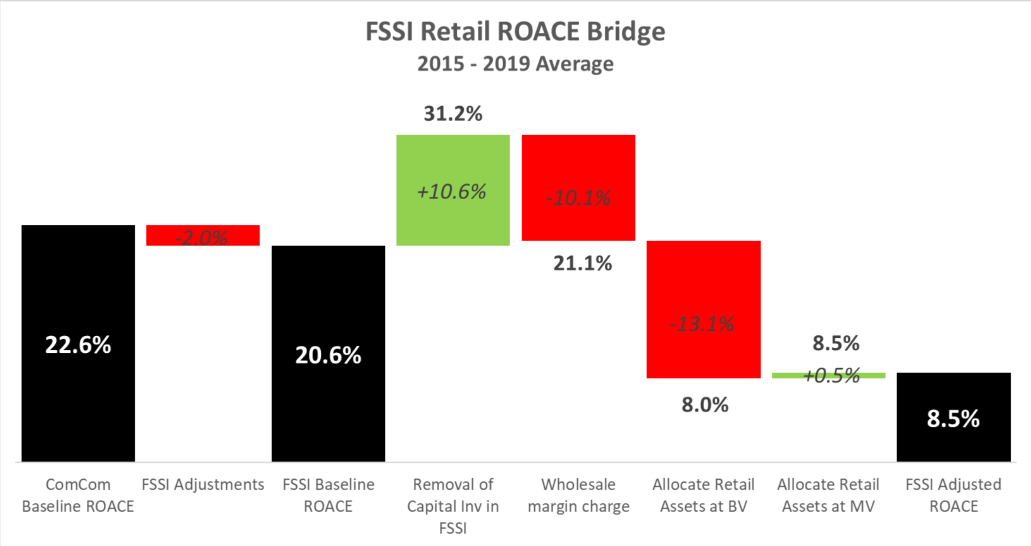
50 Incenta Consulting report at [5] and [38].

51 Incenta Consulting report at [37(b)].

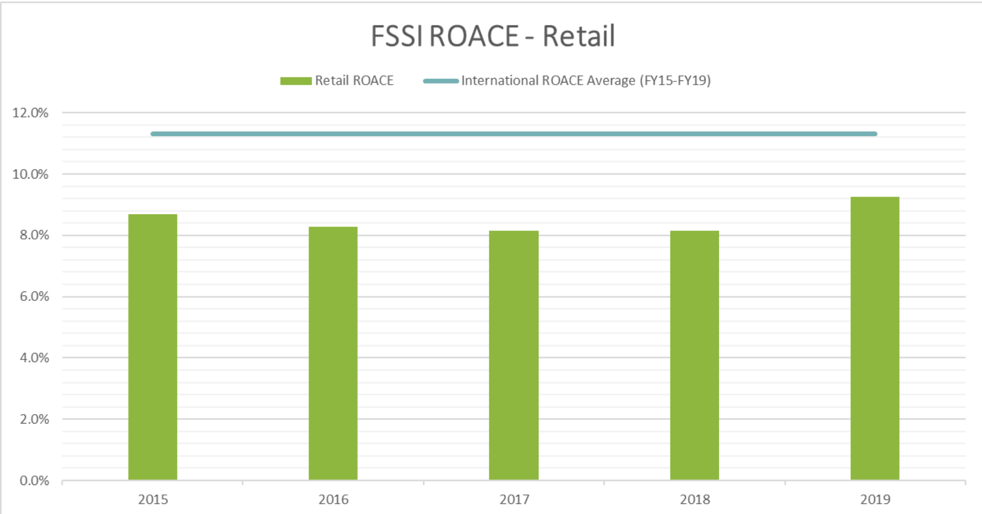
52 Incenta Consulting report at [42].

*Effect on these adjustments on FSSI retail ROACE*

86. The graph below shows the impact of the amended adjustments on the average Retail ROACE for the five-year period from 2015-2019.




87. Furthermore, with these adjustments, FSSI's retail ROACE ranges between 8.1-9.3% from 2015 to 2019. This is less than half than the retail ROACE the Commission calculated in the draft report of 23%.




***Analysis of business cases should be on a whole of business basis***

88. In order to test its assessment of profitability, the Commission has examined a number of businesses cases for new or rebuilt retail stores, as well as a small number of investments in grocery distribution centres. The Commission says this provides an insight into the forward-looking profit that grocery retailers expect to earn.[53]

53 Draft report at [3.53].

89. The Commission notes that the weighted average Internal Rate of Return (**IRR**) for these business cases is between 15% and 25%, which materially exceeds estimated WACC.[54]

90. FSSI provided three business cases to the Commission. None of the business cases specifically referred to IRR (as FSSI focus on NPV, hurdle rate and cash payback period). Therefore, FSSI assumes that this analysis does not relate to its business cases and it does not comment further, except to note that it considers any assessment of IRR must be on a whole of business basis.

91. As the Commission acknowledges, it has only assessed the IRR respect of investments in the grocery retailing part of the business only. The Commission goes on to state:

> They do not generally include those investments in land and buildings, or the property side of the business. Often the IRR returns from these investments is lower. However, we have not assessed these given these are not directly related to grocery retailing, and the investments are undertaken by the co-operative business and not the grocery store itself.

92. As explained above, the Co-operative is deeply involved in the activities of the retail stores and it is artificial to attempt to separate the two. As such, any investment decision must be considered on a whole of business basis.

***FSSI profitability and retail prices***

93. For completeness, it is helpful to consider the impact that FSSI's profitability has on the prices paid by consumers for their groceries. The inference from the draft report is that the major retailers' persistently high excess returns results in consumers paying a higher price than they should for their groceries. FSSI has sought to test that proposition by considering whether significantly reducing its profitability will result in materially lower shelf prices. FSSI's analysis demonstrates this is not the case: large changes in ROACE will only lead to small changes in price. That is because, by far, the largest component of the shelf price is the cost of the product charged by suppliers.

94. To illustrate this point, if FSSI were to reduce its ROACE to 6.1% (being the upper end of the Commission's WACC and a reasonable level of profitability) there would be minimal movement in shelf prices. Using the average performance of the FSSI Whole of Business from 2015-2019, a reduction in sales revenue of approximately $50m is required to produce a ROACE of 5.3%. This represents a 1.9% reduction in total FSSI revenue.

95. The table below shows the effect this would have on the shelf price of a typical $2.00 grocery item.

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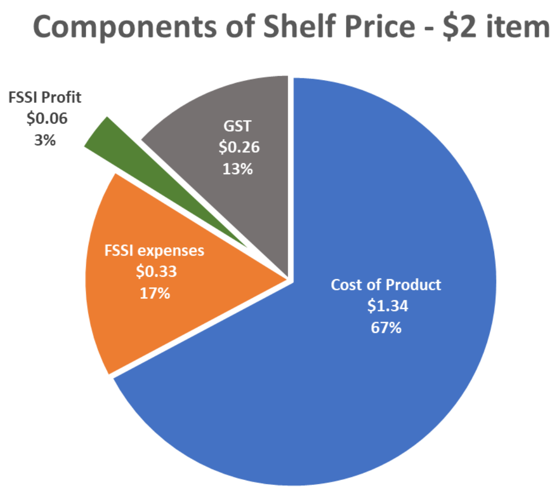
[54] Draft report at [3.54].

| | 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)*** |

96. Overall, the shelf price would reduce by $0.03 to $1.97. The reason for this is that the FSSI profit is a very small component of the shelf price.

97. The graph below illustrates the components of shelf price.




98. This analysis demonstrates that FSSI's profit is not a material component of the shelf price paid by consumers. By far, the largest price is the cost of the product paid to suppliers, which the Commission does not consider as part of the market study.

***Conclusion on profitability***

99. The analysis above demonstrates that FSSI's profitability is normal. In other words, the evidence does not support the key conclusions the Commission sought to draw in the draft report, namely that:

99.1 FSSI earns excess rates of return with an estimated ROACE of 22.6%.[55] Instead, FSSI's average WOB ROACE over 2015-2019 is 11.50%.

99.2 FSSI's ROACE exceeds the returns of the international comparator companies.[56] Instead, FSSI's WOB ROACE of 11.50% is consistent with the

55 Draft report at [3.36].

56 Draft report at [3.37].

average ROACE of the international sample of 11.32% (or 9.6%, with adjustments made to the international sample to reflect 100% ownership).

99.3 FSSI's ROACE exceeds the returns of the NZX50 companies.[57] Instead, FSSI's WOB ROACE of 11.50% is consistent with the average ROACE of comparable companies within the NZX50.

99.4 FSSI has been earning greater levels of profit margins than the overseas sample of retailers and these returns are persistent.[58] Instead, FSSI's GP margin and EBITDAR margin are consistent with, or below, the average of the international sample.

99.5 Furthermore, if the Commission continues with a profitability analysis after artificially separating FSSI into retail and Co-operative functions the outcome remains the same. FSSI's Retail ROACE of 8.50% is below the ROACE of the international sample of 11.32%.

100 In light of these conclusions, Incenta Consulting has considered the conditions under which it can be concluded that there is evidence of excess returns:

100.1 Incenta Consulting notes that there are substantial challenges with using profitability to infer whether competition is effective.[59]

100.2 However, putting those challenges to one side, Incenta Consulting explains that if profitability is to be used as a tool for testing competition, then three elements must be established before any inference can be drawn from measured profitability.[60] These elements are that:

(1) the difference between measured profitability and "normal" profitability should be "unequivocally substantial" or "significant",

(2) the profitability gap referred to above must be significant and, more specifically, endure over a sufficient period to account for fluctuations in the business cycle and investment outcomes, and

(3) for there to be confidence that the observed returns cannot be explained by superior performance.

FSSI considers that these criteria align with, and provide additional precision to, the Commission's view of the value of profitability as a tool.[61]

101 The analysis set out above demonstrates that there is no evidence of a deviation between FSSI's calculated return and a normal level of profitability, nor a deviation that is significant or has endured over time.

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[57] Draft report at [3.37].

[58] Draft report at [3.60].

[59] Incenta Consulting report at [88]-[91].

[60] Incenta Consulting report at [92].

[61] Draft report at [C4].

**New Zealand grocery prices are not high by international standards**

102. The Commission concludes that New Zealand grocery prices are higher than would be expected in a workably competitive market.[62] In large part, that conclusion is based on the Commission's international price comparison data. Further, the Commission uses its findings of persistent excess profitability to support its finding on price.[63] Given the analysis above, the Commission's findings on FSSI's profitability cannot be used to influence the Commission's conclusions on price.

103. The Commission acknowledges many of the difficulties of comparing prices internationally in a non-homogenous product market.[64] The Commission has sought to lessen the impact of these difficulties by using existing international datasets of grocery prices, presented as price-level indices.[65] Based on this analysis, the Commission concludes that, of the OECD countries in 2017, New Zealand had the sixth most expensive grocery prices[66] and the fifth highest per capita expenditure on grocery products.[67]

104. FSSI makes the following critiques of the Commission's international price comparisons:

    104.1 The Commission used market exchange rates to convert prices when PPP exchange rates ought to have been used instead,

    104.2 using PPP exchange rates, New Zealand grocery prices are not high by international standards (based on HoustonKemp's price comparison work). Instead, New Zealand grocery prices fall in the middle of OECD countries in 2017,

    104.3 in any event, international price comparisons say little about competition. The Commission has not tried to determine whether apparently higher prices in New Zealand are the result of relatively less competition or are due to other factors. HoustonKemp's analysis demonstrates that it is difficult to draw a link between the level of grocery prices and the nature and effectiveness of competition in New Zealand:

        (a) despite having a larger number of grocery retailers, the price of food has increased in Australia at a very similar rate to that of New Zealand, and

        (b) 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 approximately 2%. Further, this would barely affect New Zealand's overall ranking in the OECD, and

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62 Draft report at [3.69].

63 Draft report at [3.69].

64 Draft report at [3.86].

65 Draft report at [3.87].

66 Draft report at [3.101].

67 Draft report at [3.103].

104.4 as a result, the Commission is not able to draw any reliable inference about the level of competition in New Zealand from the international price comparisons.

105. Finally, FSSI notes that the Commission cites consumer research indicating that consumers believe prices in New Zealand are high, including compared to other countries. As the Commission acknowledges, these anecdotal comments are not evidence of prices being higher than a workably competitive market.[68]

***PPP provides the most meaningful comparison of international grocery prices***

106. The Commission adopted market exchange rates rather than PPP to convert grocery prices. The Commission ought to have used PPP, as it has done in a range of other contexts.

107. While the Commission acknowledges that either market exchange rates or PPP could be used, it preferred to use market exchange rates because:[69]

107.1 this was the same approach the Commission adopted in the fuel market study,

107.2 PPP is not appropriate for grocery products, which are largely tradeable, and

107.3 PPP might reduce the price effects that the Commission is interested in.

108. HoustonKemp concludes that PPP is the more appropriate for comparing grocery prices because:[70]

108.1 contrary to the Commission's assumption, grocery services in New Zealand are not traded with other countries, nor are many key aspects of the cost of supplying grocery services: labour, land, distribution services, professional services and locally produced groceries.

108.2 A high-income country like New Zealand is likely to have higher costs for these products and services than lower-income countries. This will likely bias prices upwards when using a market exchange rate. Consistent with this, it is recognised that market exchange rates tend to overstate price levels in high-income countries and understate price levels in low-income countries,[71] and

108.3 groceries account for only a small proportion of GDP. Calculating a PPP using expenditure across the economy should therefore not substantially reduce the price effects between grocery items.

109. Use of PPP is consistent with that recommended by the OECD.[72] Further, PPP has been used by the Commission in a range of contexts. For example:

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68 Draft report at [3.75].

69 Draft report at [3.89].

70 HoustonKemp International comparisons of grocery prices at [57].

71 HoustonKemp International comparisons of grocery prices at [55].

72 HoustonKemp International comparisons of grocery prices at [60].

109.1 the Commission used PPP in the draft report to compare the incomes of countries to find those that would be most similar to New Zealand,[73]

109.2 the Commission's determination of prices for the unbundled copper local loop (UCLL) in 2012 used the mid-point between market exchange rates and PPP rates.[74] The Commission noted that:

> The blended approach to currency conversion reflects the components of the UCLL monthly rental service. Approximately 50% of local network costs relate to non-tradeable components (such as labour), and the other 50% relate to tradeable capital inputs.

109.3 the Commission uses PPP in its Annual Telecommunications Monitoring Report, published 16 March 2021 to benchmark the price for New Zealand broadband and mobile plans against the OECD.[75] In that report, the Commission refers to PPP as "generally accepted as an appropriate conversion method for non-tradable goods and services".

110. Finally, while the Commission used market exchange rates in the fuel market study, this was appropriate as the largest contributor to the cost of retail fuel is imported crude oil or refined petroleum. Both of these are internationally traded commodities.[76] However, as explained by HoustonKemp it is unlikely to be reasonable to assume that inputs to grocery services are also internationally traded commodities.[77]

111. Therefore, any analysis of international prices ought to be carried out using PPP exchange rates.

***New Zealand's grocery prices are not high compared to other OECD countries***

112. HoustonKemp has analysed OECD grocery prices using PPP exchange rates. This analysis demonstrates that New Zealand grocery prices are not high in comparison to other OECD countries.[78] This can readily be observed from the figure below,[79] which shows that New Zealand sits approximately in the middle of the OECD countries.

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[73] Draft report, page 408.

[74] HoustonKemp International comparisons of grocery prices at [63].

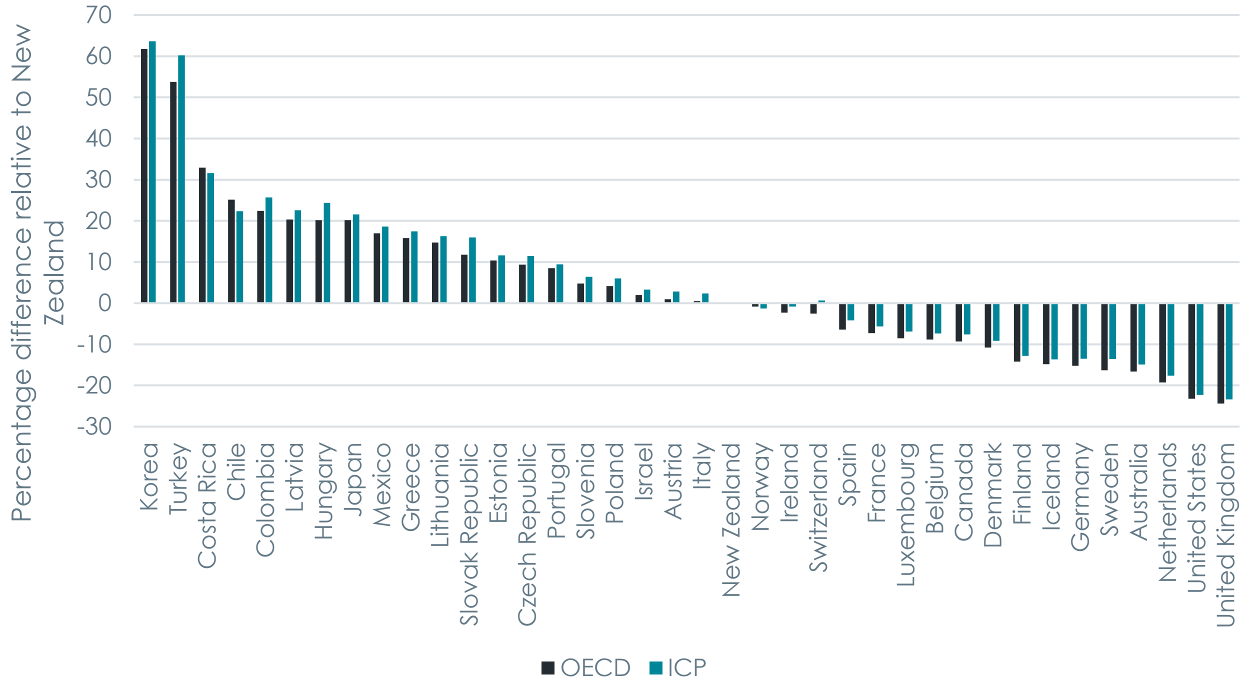
[75] https://comcom.govt.nz/__data/assets/pdf_file/0030/247377/2020-Annual-Telecommunications-Monitoring-Report-Revised-version-16-March-2021.pdf.

[76] HoustonKemp International comparisons of grocery prices at [61].

[77] HoustonKemp International comparisons of grocery prices at [61].

[78] HoustonKemp International comparisons of grocery prices at [66].

[79] See HoustonKemp report, Figure 3.1. This shows the percentage difference in food and non-alcoholic beverage prices compared to New Zealand.




113. Even then, care is needed when comparing prices between countries, given that changes in prices can be caused by a range of factors.

***It is not possible draw any reliable inference about competition from the international price analysis***

114. The analysis above has demonstrated that New Zealand does not have high grocery prices by international standards. However, in any event, international price comparisons say little about the level of competition in New Zealand.

115. In its submissions on the preliminary issues paper, FSSI noted this precise difficulty.[80] In particular, FSSI explained that a higher price in New Zealand could be due to a range of factors, such as a lack of competition, but equally also local input costs being higher in New Zealand than overseas or the costs of operating a chain of supermarkets being higher in New Zealand than overseas.[81] Supplier choices about pricing is another obvious factor that may affect price levels between countries.

116. The Commission accepts this proposition at multiple points in the draft report. Three examples are quoted below:

> Factors other than competition are likely to affect prices relative to other countries. Examples of these for New Zealand may include our geographic location, biosecurity regulations, labour and distribution costs.[82]
>
> As noted previously, there are a range of potential reasons why prices may be higher in New Zealand than in some other countries. For example, costs may vary depending on the size and scale of a country.[83]

80 FSSI Submission on Preliminary Issues Paper, answer to Q20.

81 HoustonKemp also discusses the factors that may affect grocery prices: HoustonKemp International comparisons of grocery prices at [37]-[42].

82 Draft report at [3.85.2].

83 Draft report at [3.112].

> It is not possible to determine exactly how much of the price differences we observe can be attributed to inter-country differences in competition or any other factors...[84]

117. The Commission attempts to get around this difficulty by comparing New Zealand's prices to five particular countries, which it says are comparable to New Zealand in terms of scale and size and could face similar demand and supply factors.[85] Even then, the Commission notes that there are significant differences between the comparator countries and New Zealand.[86] To take Australia as an example, the Commission notes that the population of Australia is five times that of New Zealand, the population density is significantly lower, that population is more clustered in urban areas, and the climate and landscape are difference. The Commission says it is unclear how these factors affect comparisons between Australia and New Zealand.[87]

118. The Commission expresses the limitations of its analysis as follows:[88]

> These comparisons are for illustrative purposes and we acknowledge that caution must be exercised when comparing prices of any two particular countries. The determinants of price are complex and different factors will determine grocery prices in every country; no country will perfectly mimic New Zealand's determinants of price.

119. While the Commission concludes that New Zealand prices are higher than the average for this smaller comparator group (using market exchange rates),[89] it has not tried to determine whether higher prices in New Zealand are the result of relatively less competition compared to the comparator group, or other factors. In particular, the Commission does not undertake any calculations, analysis or adjustments seeking to normalise or account for factors that might differ between countries, other than the degree of competition.[90]

120. As such, it is difficult to draw any reliable conclusions from analysis regarding the degree of competition between grocery retailers in in New Zealand relative to other countries.[91]

121. It is for this reason that the UK Competition Commission declined to carry out an international price comparison to support its analysis in its 2008 grocery market study noting that:[92]

> International comparisons of prices and price trends are another means of looking at the effectiveness of competition between grocery retailers. There are, however, several problems associated with international price comparisons. Different countries have different consumer tastes and shopping behaviour, for example, that lead to substantial differences in the structure of grocery retailing. Further, exchange rate issues, difficulties in the comparability of products and pack sizes, differences in the role of tax in food prices, and different property markets and planning regimes all impact differentially on the prices of groceries in different countries. Moreover, price is only one aspect of the grocery retail offer,

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[84] Draft report at [3.113].

[85] Draft report at [3.113] and [3.114].

[86] Draft report at [D36].

[87] Draft report at [D36.1].

[88] Draft report at [D32].

[89] Draft report at [3.115].

[90] HoustonKemp International comparisons of grocery prices at [34].

[91] HoustonKemp International comparisons of grocery prices at [44].

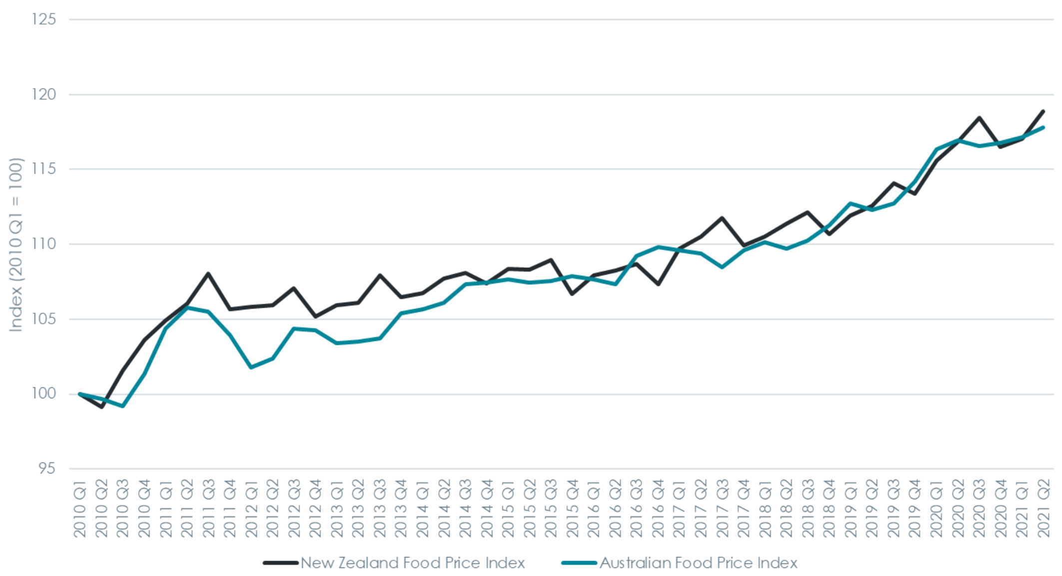
[92] The Competition Commission *The supply of groceries in the UK market investigation* (30 April 2008) at [3.43]-[3.45].

> and grocery retailer margins may provide a better indication of the effectiveness of competition...
>
> ... We believe there is only limited value to be gained from an extensive cross-country comparison of grocery prices for the purpose of an informing an assessment of the effectiveness of competition in UK grocery retailing. As a result, we have not sought to further inform our investigation through such an analysis.

122. Further, HoustonKemp has carried out analysis which demonstrates that a lack of competition is not driving differences in price compared with other countries.

*New Zealand's grocery price inflation is consistent with Australia*

123. Australia has a larger number of grocery retailers than New Zealand and, Aldi, one of the smaller retailers has nearly doubled in size between 2011 and 2021.[93] Despite that, the price of food has increased in Australia at a very similar rate to that in New Zealand. This is set out in the figure below.[94]




124. 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.[95]

*Profitability: an alternative analysis*

125. HoustonKemp puts forward an alternative basis for testing the Commission's view that New Zealand grocery prices are higher than in a workably competitive market. In particular, HoustonKemp has re-run the price comparison analysis assuming that New Zealand grocery prices were 2% lower. As discussed above, this is the amount by which grocery prices would decrease if FSSI's profitability was consistent with the Commission's best estimate of WACC (5.3%). For the purposes of this analysis, HoustonKemp has used the Commission's price comparison analysis without amendment.

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93 HoustonKemp International comparisons of grocery prices at [67].

94 HoustonKemp International comparisons of grocery prices, Figure 3.2.

95 HoustonKemp International comparisons of grocery prices at [69]-[70].

126. HoustonKemp demonstrates that if FSSI's profits were reduced to WACC, with a 2% change in grocery prices, there would be no material change in New Zealand's international ranking of grocery prices. That is, New Zealand would be ranked seventh, instead of sixth, out of 38 countries.[96] On HoustonKemp's analysis, if prices were to fall 1%, representing a reduction in FSSI's profit, but not to the mid-point of WACC, then New Zealand's international ranking would remain unchanged.[97] This reinforces the view, above, that New Zealand's ranking in terms of grocery prices, cannot be explained to any meaningful extent by the nature or effectiveness of competition in the grocery sector and its potential effects on profitability of the major grocery retailers. Rather, it must be that other factors are principally responsible for New Zealand's international price ranking.[98]

127. As noted above, the largest component of grocery prices is the cost price paid by the retailers to suppliers, which FSSI calculates is 67% of the shelf price.

**FSSI is innovative and the pace and scale of its innovation is appropriate for the New Zealand market**

128. The Commission's overall findings is that:

128.1 The major retailers primarily focus innovation on range and service, rather than price, and

128.2 The level of innovation is below that which could be expected given the major retailers profitability.[99]

129. Again, caution is needed when using excess profitability as a reason for finding that levels of innovation are comparatively low, given the revised profitability estimates show that FSSI's returns are normal.

130. FSSI considers that contrary to the Commission's perspective, it competes strongly on price as detailed below. In addition, FSSI is, and strives to be, an innovative business, for the benefit of its customers. Further, it considers that the pace and scale of its innovation, in each of the categories the Commission looks at, is appropriate for the New Zealand market.

131. FSSI's key points, in relation to each of the different categories of innovation, are that:

131.1 *innovation at bricks-and-mortar stores*: FSSI has implemented, or has plans to implement, various innovations at its bricks-and-mortar stores. Further, while FSSI closely monitors overseas innovations at Board level and is an innovative business, given New Zealand's size, it is not realistic to expect FSSI to adopt innovations at the same speed and scale as in larger overseas markets,

131.2 *service differentiation*: service differentiation is an important factor for customers, and FSSI competes vigorously on this factor,

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[96] HoustonKemp International comparisons of grocery prices at [78].

[97] HoustonKemp International comparisons of grocery prices at [82].

[98] HoustonKemp International comparisons of grocery prices at [80] and [84].

[99] Draft report at [3.141].

131.3 *online shopping:* this is being rolled out to meet consumer demand for convenience

131.4 *product innovation*: FSSI offers a wide range of new products and often partners with suppliers to launch new and innovative products, and

131.5 *supply chain innovation*: FSSI has invested heavily in its supply chain to improve the shopping experience for consumers and its robustness which has been demonstrated during the COVID lockdowns.

***There is real innovation at bricks-and-mortar stores***

*FSSI has significant existing and planned innovation*

132. FSSI has invested in a number of innovations at its bricks-and-mortar stores, which the Commission overlooks in the draft report.

133. FSSI has introduced Shop'nGO to its PAK'nSAVE stores and some New Worlds. Customers are provided with a handheld device that allows them to scan and pack their groceries as they shop and track their spend. They then pay at a self-checkout unit without having to rescan their groceries.

134. FSSI also introduced electronic shelf labels in all its PAK'nSAVE and most New World stores as well as some Four Squares. This is a significant investment to ensure consumers see accurate pricing at the shelf and minimises the risk of inadvertent pricing errors at the checkout as the shelf and checkout prices are linked.

135. Most PAK'nSAVE, New World and many Four Square stores also have:

135.1 electric vehicle chargers installed; and

135.2 Free Wifi instore for customers.

136. There have also been a range of innovations at store level of the kind referred to by the Commission in the draft report.[100] For example, FSSI stores feature:

136.1 self-serve dog treats bars,

136.2 peel your own pineapple machines,

136.3 self-serve nut butter machines,

136.4 specialty areas in store stocking health products, and

136.5 Ecostore refill stations

137. FSSI has also introduced "Food in the Nude", an initiative aimed at removing plastic from produce displays in stores and worked with suppliers to introduce a range of sustainable packaging options for example recyclable meat trays.

138. Further, FSSI closely tracks overseas innovations, including at senior levels of the Co-operative (Board level) through research and (what were) regular overseas trips to international grocery conventions such as PMA Fresh Summit – produce summit held in USA, EuroShop and visits to other international grocery markets to share

[100] Draft report at [3.161.4].

trends (e.g. China, UK, USA, Australia, Singapore, Japan, France, Germany, Denmark, Netherlands, amongst others). An analysis of FSSI Board packs shows active monitoring of innovation in international markets, as well as consideration of whether these FSSI should adopt the innovation.

139. FSSI innovations have been recognised overseas. Wanzl GmbH & Co, a German company that specialises in retail solutions, featured the store layout of New World Durham Street in its 2020 Workbook 3.0 on the occasion of Euroshop 2020.

***The pace and scale of innovations is healthy in the context of New Zealand's population and economy***

140. Caution is required when comparing the pace and scale of innovations in New Zealand to those overseas. FSSI is actively monitoring and considering overseas innovations for its stores. Of course, given "the smaller size of the economy and population"[101] in New Zealand, it is not realistic to expect FSSI to adopt these innovations simultaneously with their release in much larger markets overseas.

141. Many of the overseas countries that the Commission uses as comparisons are markedly different to New Zealand, including with the presence of large multinational companies. Further, many of the innovations that the Commission has noted are novel to even the much larger markets they are occurring in.

142. A particular example of this is the Commission's reference to cashierless stores in the US and UK launched by Amazon through its Amazon Go store format.[102] As the Commission notes, these stores are new. In particular, Amazon Go only launched in the UK in March 2021.[103] Further, the hardware in each Amazon Go store alone is estimated to cost approximately $USD 1 million.[104] It is simply not realistic to expect FSSI to keep pace with Amazon, a large multinational corporate, especially when this particular innovation represents a significant financial undertaking.

143. FSSI considers that it is an innovative business, and the pace and scale of innovations at its bricks-and-mortar stores are appropriate for New Zealand.

***Service differentiation is important to consumers***

144. FSSI considers that service differentiation is a very important factor for consumers. As a result of the trend toward missions shopping (discussed further below), convenience is increasingly a driver of store choice for consumers, especially on smaller shopping missions. FSSI faces strong competition on this front from many smaller retail outlets and specialist stores. It has invested in a range of innovations that respond to this competition and customers' desire for convenience. In particular, FSSI has:

144.1 increased emphasis on minimising the customer burden of entering a large, full range supermarket through means such as introducing "cut throughs" in

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[101] Draft report at [3.165].

[102] Draft report at [3.161.3].

[103] See: https://www.forbes.com/sites/markfaithfull/2021/03/01/amazon-bets-on-britain-as-amazon-go-set-to-launch-in-london-this-week/?sh=7b1464fd70d3

[104] See: https://www.forbes.com/sites/andriacheng/2019/11/21/thanks-to-amazon-go-checkout-free-shopping-may-become-a-real-trend/?sh=7d3b21a1792b

nearly all stores, and self-check outs, to improve convenience for customers on smaller missions,

144.2 trialled Pam's Pantry, an ultra-convenient, value driven small footprint supermarket for urban environments;

144.3 dedicated bag packers at its New World stores;

144.4 implemented serve over cabinets for seafood, meat and deli in its New World stores;

144.5 developed instore cafe offerings in many of its PAK'nSAVE and New World stores.

145. FSSI's focus on innovations to support consumers' desire for convenience is consistent with the results of the Commission's consumer survey. The results of this survey are discussed in more detail in "The nature of competition in the retail grocery sector" section of this submission, but one set of the questions is relevant to consumers' desire for convenience. Questions 12 and 13 of the survey asked customers to identify, from a range of 19 different factors, why they chose their main store. Question 12 allowed them to select multiple answers, whereas question 13 required them to select only one answer. Convenience was the highest ranked answer:[105]

145.1 when consumers could only select one reason for choice of main store, 20% chose "convenient/easy to get to", and

145.2 when consumers could select multiple reasons for choice of main store, nearly 50% selected "convenient/easy to get to" as one of the reasons.

146. This indicates that convenience – or as it was described in the customer survey "convenient/easy to get to" – is the most important factor driving store choice for consumers. It is therefore appropriate for FSSI to have focussed on convenience, for example, through developing cut throughs instore (as well as focusing on location when developing new sites).

147. The Commission notes that its consumer research demonstrates consumers would prefer price differentiation to service and product differentiation.[106] The Commission's own consumer research does not support that view. In particular, in response to Questions 12 and 13:

147.1 when consumers could only select one answer, slightly over 15% chose "low prices overall". In other words, 85% of respondents did not consider low prices to be the determinative factor in store choice, and

147.2 when consumers could select multiple answers, 30% selected "low prices overall". In other words, 70% of respondents did not consider low prices to be a determinative factor in store choice.

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[105] Draft report, Fig F20.

[106] Draft report at [3.145].

148. Further, as explained in the next section, price was particularly a driver for consumers shopping at PAK'nSAVE – PAK'nSAVE has appropriately focussed its competition on price, rather than QRS, factors.

149. The Commission therefore has no basis to discount FSSI's service or product innovations.

150. Finally, FSSI notes that, in response to the Commission's finding that no food discounter type business model innovations have occurred in New Zealand, that Costco is due to open in New Zealand in 2022, with that exact business model. FSSI addresses the likely impact of Costco's entry later in this submission, but notes that [ ].

***FSSI engages in material product innovations***

151. FSSI category teams work closely with many vendors providing insights around new product development. In many instances, vendors provide new product plans to our category team twelve months prior to product launch dates, to seek advice and expertise around category and customer insights. FSSI works closely with small artisan/regional vendors to assist supply into our stores. During 2020, FSSI ranged 4,675 new products and added an additional 7,042 instore articles.

152. In 2018 FSSI initiated its annual Foodstarter competition. This is a food innovation competition looking for innovation across the entire grocery sector. There are two categories for entry. The first category is for startups in the food and beverage sector who have a product, are at early stages of trading, but are not yet selling to the New World network. The second category is small suppliers who have registered as a vendor with New World and might be selling to a limited number of stores

153. This program is an opportunity to help small businesses get their products on the shelf at FSSI supermarkets. In the first year, the competition attracted almost 100 entries from small producers around New Zealand.

154. FSSI stocks an incredibly wide range of products across its stores. In 2020 in total, across PAK'nSAVE, New World, Four Square, Raeward Fresh and Trents, FSSI ranged 82,473 different products and introduced approximately 8,800 products into store.

155. As acknowledged by the Commission, FSSI has invested in providing a more diversified product range, including increasing the availability of healthy/organic products and providing prepared meal options.[107] Recent examples of this include:

155.1 The launch of Pams Plant Based range in June 2020. This reflected an investment in new product development in the meat alternatives category, which is a new and fast-growing product category, and

155.2 Pams finest, a range of gourmet and artisan products, featuring high quality natural ingredients and no artificial colours or flavours, and

155.3 Partnering with New Zealand business with innovative product offerings and supporting their entry into stores. This includes:

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[107] Draft report at [3.143].

(a) Harris Meats, a family owned North Canterbury meat processing company, specialising in farm to plate solutions and providing retail ready meat solutions to FSSI retail banner store, and

(b) Lilo Plant based Cheese Cakes winner of the 'start up' category in the 2021 FSNZ Food Starter Awards.

***FSSI's online offer reflects a healthy level of innovation***

156. The Commission finds that Foodstuffs' stores lag in digital innovation and penetration, but earn persistently high excess returns. FSSI's returns have been discussed above, and they are not excessive.

157. FSSI is in the process of rolling out online shopping in both New World (click and collect and delivery) and PAK'nSAVE (click and collect). Click and collect is being implemented using a concierge service, which we believe is equivalent, if not superior to the drive through option referenced in the draft report.

158. FSSI has taken a tailored approach to online shopping across its banners. As explained later in this submission, differentiation of the competitive offering on PQRS[108] factors is a normal part of the competitive process. As an example, FSSI considers that it is normal, and acceptable, for PAK'nSAVE's competitive offering to focus on having New Zealand's lowest food prices, in favour of, for example, adding cost to offer delivery for online shopping.

***FSSI's supply chain delivers real value for New Zealanders***

159. FSSI continues to introduce supply chain innovations to benefit the consumer. The Commission refers to FSSI having opened a new ambient distribution centre in Christchurch in 2015.[109] FSSI has made many other investments in is supply chain. For example:

159.1 In December 2018 FSSI opened a new Temperature Controlled Distribution Centre (DC) in Hornby Christchurch. This has allowed FSSI to expand its centralised produce product ranges and has resulted in consistent quality and freshness of products through daily delivery into store.

159.2 Cross Dock: the same day arrival into the DC and distribution of products to store, has enabled vendors of non-ranged, fresh products to utilise our Supply Chain network to get their products into our stores, but who otherwise do not need to supply product to be held in our DC's.

159.3 Advances in Repack picking systems has improved its ability to distribute small numbers of many products across our retail store network throughout the South Island. This is especially important for our smaller retailers who can then provide a more extensive range to their customers.

159.4 FSSI committed to a supply agreement with a fresh milk processing company. This extended commitment enabled the vendor to install highly advanced material handling equipment that manages the picking and dispatch of fresh

[108] Price, quality, range and service.

[109] Draft report at [3.169].

milk orders. This provides our retail customers with the freshest milk products possible, daily.

160. As acknowledged by the Commission, FSSI has invested heavily in its supply chain, the resilience of which has been demonstrated during the COVID-19 pandemic.[110] The Commission's conclusion is that consumers do not benefit from these investments given the persistent high levels of profitability and price. However, as discussed in detail above, it is not accurate to say that FSSI's profits, and New Zealand grocery prices, are persistently high. FSSI's investments in the supply chain, considered in that light, show that FSSI is delivering value for its customers.

## THE NATURE OF COMPETITION IN THE RETAIL GROCERY SECTOR

### Summary of FSSI's key points

161. FSSI considers that competition is working well. In preparing this submission, we have reviewed Foodstuffs North Island's (FSNI's) comments in the section of its submission entitled "The main shop does not comprise the majority of FSNI's sales or baskets". FSSI is still developing capability to analyse customer shopping missions in this manner. We endorse FSNI's submissions in that section of its submission and adopt them for the purposes of this submission.

162. In particular, we would note that FSSI's average basket spend for 2019 was, for each banner:

    162.1 Four Square: [ ].

    162.2 New World: [ ].

    162.3 PAK'nSAVE: [ ].

163. The above average basket spends are very similar to FSNI recorded basket spends for the same period.[111] Accordingly, FSSI is comfortable that FSNI's analysis of basket data would be equally applicable to FSSI.

### *The Commission's consumer research is consistent with shopping missions*

164. The Commission's consumer research demonstrates that consumer shopping behaviour is consistent with shopping missions, rather than the main shop. That is, the data is consistent with customers conducting more frequent smaller shopping missions, rather than purchasing all of their grocery needs in a single visit to a single store. The consumer research demonstrates that:

    164.1 consumers carry out a number of shopping trips per week,

    164.2 consumers visit a range of different stores per week, including both major retailers and other retailers,

    164.3 consumers' basket size tends to be smaller, rather than larger, and

    164.4 consumers' choice in store is driven by convenience.

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[110] Draft report at [3.169] [3.171].

[111] FSNI submission, see section "Basket size is consistent with missions shopping".

165. These are the characteristics of missions shopping.

*Consumers carry out a number of shopping trips per week*

166. The Commission's consumer survey asked respondents which retailers they shopped with each week (question 5) and in respect of those retailers, how many times they shopped with each retailer in a given week (question 6). The responses to question 6, when aggregated, give the total number of individual shopping trips in a given week.

167. The results of this analysis, set out in HoustonKemp's report, demonstrate that less than 12% of respondents carry out one shop per week. Put another way, 88% of respondents carry out at least two shops a week. And, two thirds of respondents (67%), carry out three or more shops a week. Analysing the data a different way, the average number of shopping trips per respondent was 3.7 trips.[112]

168. This is consistent with missions shopping, as it shows consumers are carrying out a number of shopping trips per week. By contrast, if the main shop was prevalent, then the average of shopping trips per week should be closer to 1.

169. FSSI notes that this result is particularly significant, given the under-representation of people aged 16-40 years in the consumer survey. Figure F6 shows that although people aged 16-40 years make up 43% of the population, they made up only 17% of respondents. By comparison, those 40-65 years makes up 57% of the population but 83% of respondents.

170. This imbalance is significant because FSNI research indicates that missions shopping are less common amongst people aged 55 and over. The over-representation of this age group in the consumer survey means it is likely that the survey results overstate consumers' preferences for a shopping once a week and understate consumers' preferences for missions shopping.

*Consumers visit a range of different stores each week, including major retailers and other retailers*

171. Question 5 of the consumer survey asked customers to select, from a range of stores (or categories of stores), the stores that they would buy groceries from in a typical week.[113] The responses demonstrate that most consumers visit more than one store a week:[114]

171.1 24% of respondents visit only one store,

171.2 37% of respondents visit two stores,

171.3 24% of respondents visit three stores,

171.4 10% of respondents visit four stores, and

171.5 just under 5% of respondents visit five or more stores.

172. Put another way, 76% of customers visited more than one store a week. This result is consistent with missions based shopping, with customers visiting a range of stores

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112 HoustonKemp report on empirical evidence of grocery sector competition at [73].

113 Question 5 (Draft report, page 491).

114 Draft report at [F87] and Figure F9.

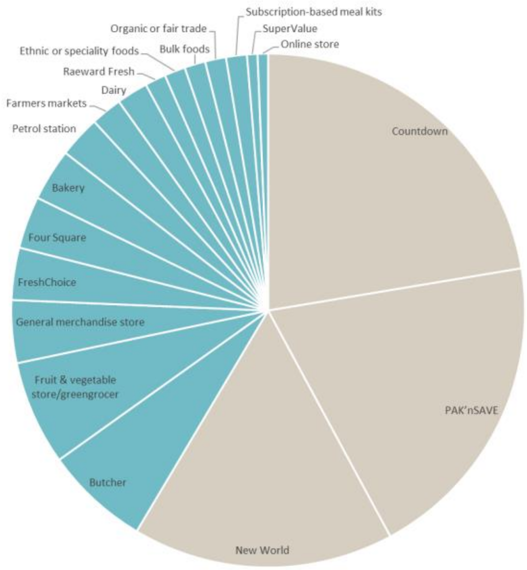
on different missions to fulfil their grocery needs. By contrast, a main shop is typified by consumers visiting a single store to buy all their shopping needs in one trip. Only 24% of consumers shopped at one store per week (and even then, it is not clear how many times these customers visited that store in a typical week).

173. Ispos found similar results in its study. One of the questions in the Ipsos questionnaire asks participants to select from a list the stores that they "mainly" do their grocery shopping at.[115] If the number of stores is divided by the participants in the Ipsos study, there is an average of 2.6 stores selected by each participant as places that they mainly shop at.[116]

174. Further, both the consumer survey and the Ipsos research indicate that consumers shop at a mix of both major retailers and other retailers. For example:

174.1 the results from the consumer survey indicate that 60% of respondents visit only the major grocery retailers and 40% visit a mix of the major retailers and other retailers,[117] and

174.2 in the Ipsos study, in relation to the question of where respondents "mainly" shopped, 41% of responses were for retailers other than Countdown, PAK'nSAVE and New World (noting that participants could give more than one response).[118] This is set out graphically below:[119]




175. In addition, Ipsos specifically reported that, in relation to where participants mainly shopped (emphasis added):[120]

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115 Ipsos report, page 32.

116 HoustonKemp report on empirical evidence of grocery sector competition at [85].

117 Draft report at [F90] and figure F11.

118 HoustonKemp report on empirical evidence of grocery sector competition, at [60].

119 HoustonKemp report on empirical evidence of grocery sector competition at [60] and Figure 2.1.

120 Ipsos report, page 34.

> **Very few participants shopped for groceries only at a supermarket**; most participants also used a full range of grocery locations including Saturday markets and Asian food stores. In Table 6, the breakdown of use of different grocery shop locations is tallied based on the participant's response to the... question regarding places they mainly do their grocery shopping. **Many indicated more than a one-shop type as places they mainly do their grocery shopping**.

*Basket size tends to be smaller, rather than larger*

176. Question 7 in the consumer survey asked respondents to specify, for each store they shopped at in a typical week, the amount of their total spend at that store. HoustonKemp's analysis of the responses to that question demonstrates that basket size tends to be smaller, rather than larger. In particular:[121]

176.1 the average basket value is $67,

176.2 approximately 57% of respondents' shopping trips have an average spend of less than, or equal to, $50, and

176.3 approximately 81% of respondents have an average spend of less than, or equal to, $100.

177. This is consistent with FSSI's internal sales data, where the average basket size at each banner was [ ].

178. Smaller value baskets are indicative of missions shopping, as that is typified by customers carrying out a number of smaller shops, rather than a single shop with a high value basket.

*Convenience is the main driver of store choice*

179. Missions shopping is often driven by convenience. For example, a customer on the "in home snacking" mission is most likely to purchase that mission from a retailer that is close to their current location. Likewise, a customer on the "cooking from scratch mission" may purchase that mission on the day it is required, perhaps from a conveniently located retailer on their way home from work. By contrast, the main shop is typified by the customer having access to a wide range of grocery items, so that they can purchase all their necessities in a single shop.

180. As discussed above, one of the questions in the consumer survey asked consumers to choose why they visited their main store[122] from a list of 19 reasons. Respondents were able to select as many reasons as they liked. A second question asked respondents to identify the single most important reason.[123] Again, the responses were consistent with missions shopping. In particular:

180.1 the most frequent answer was "convenient/easy to get to". When consumers could select more than one answer, nearly 50% selected this as an answer. Just over 20% of respondents chose it as their main reason for visiting the store, and

180.2 a less frequent answer was "wide choice of products". That answer seems to align most with the concept of a one-stop shop, which is driven by consumers having access to the full range of products in a single location. If the

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[121] HoustonKemp report on empirical evidence of grocery sector competition at [74].

[122] Main store was defined as the store consumers spend the most at, or do most of their grocery shopping with: question 9 (Draft report, page 492).

[123] Question 12 and 13 (Draft report, page 493).

Commission's thesis, that the main shop is dominant, is correct, then it could be expected that the majority of respondents would select this answer as the reason for choosing their main store. However, when consumers could select more than one answer, only approximately a third selected "wide choice of products". When consumers could select only one answer, under 10% chose this answer.

181. Based on this evidence, the drivers of store choice also align with mission shopping. By far, the most important factor driving store choice was convenience/ease of location. This is an essential characteristic of mission shopping.

***The consumer research referred to by the Commission does not support its main shop analysis***

182. Having considered the parts of the consumer research that support the prevalence of missions shopping, the submission now considers the parts of the research that the Commission relies on to say the main shop is dominant. FSSI considers that, as set out in HoustonKemp's report on empirical evidence of grocery sector competition, the research does not support the propositions the Commission seeks to draw from it.

*The Commission's classification of a main shop is not matched in the surveys*

183. The Commission defines a main shop as a shop typically happening weekly or at another regular interval based on the convenience of using one grocery store to get all the necessities in one place.[124] However, neither the consumer survey, nor the Ipsos study, incorporated this concept into their definition of a main shop:

183.1 the consumer survey asked consumers to select their main grocery store from a list of retailers. However, main store was defined as "the one you spend the most at, or do most of your grocery shopping with",[125] and

183.2 the Ipsos report asked participants to select where they "mainly" shopped (and separately, where they "typically" shopped).[126]

184. Neither of these definitions incorporated the concept of the main shop as defined by the Commission i.e. a shop where consumers benefit from the convenience of buying all items in one location. Indeed, both questions allowed respondents to select more than one store.[127] As noted above, respondents in the Ipsos survey selected an average of 2.6 stores.

185. Ipsos reports that, during the focus groups and individual interviews, participants indicated they undertook a single main shop at a major supermarket:[128]

> During the discussions and interviews, most participants noted having a single main shop at a major supermarket and visit these [other] locations to supplement their full grocery order as a top-up if they ran out of something.

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[124] Draft report at [4.18.1].

[125] Draft report, page 492.

[126] Ipsos report, page 34, question 16, and question 15.

[127] The consumer survey allowed respondents to select a maximum of two stores. There was no limit in the Ipsos study.

[128] Ipsos report, page 34.

186. However, Ipsos does not provide any express support for this statement, nor explain how consumers conveyed their preference for a single main shop, i.e., whether this answer was given in response to a leading question posed in discussions or interviews, or whether it was pro-offered without prompting. Ipsos also does not describe how many participants expressed a preference for a single main shop.[129]

187. The Ipsos report also appears to provide the basis for the Commission's concept of a main shop being rooted in convenience:[130]

> Most participants preferred the convenience of shopping in one location and getting their full basket at once.

188. Again, Ipsos does not provide any express support for this statement, nor an explanation of the discussion underpinning Ipsos' summary of a main shop.

*The Commission's finding that most consumers do a main shop is not reliably supported by its evidence*

189. One of the questions in the consumer survey (question 4) asked consumers to select, from four options, the option that best described how they usually shopped for groceries each week. The options included:

189.1 I tend to do one or two larger shops and a few smaller shops,

189.2 I tend to make one or two large shops,

189.3 I do several smaller shops, and

189.4 None of these, I do less than one shop a week.

190. The Commission relies on the results from this question to conclude that most consumers tend to do at least one large shop a week.[131] Presumably, the Commission uses this finding to then infer that most consumers prefer to carry out a main shop.[132]

191. However, the response to question 4 does not support a conclusion that most consumers tend to do a main shop. The question simply asked consumers whether they carried out "large" or "small" shops. A large shop does not necessarily encompass the requirements of a main shop i.e. a shop for all grocery needs at a single store, based on the convenience of buying everything in one place.

192. Further, the question was open to differing interpretations by respondents: [133]

192.1 the term "large" is subjective and would likely have been interpreted differently across respondents. For example, two respondents could both select that they undertake one or two large shops (and potentially other smaller shops) with the first respondent undertaking one large shop of $50

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[129] HoustonKemp report on empirical evidence of grocery sector competition at [59].

[130] Ipsos report, page 15.

[131] Draft report at [4.71].

[132] Draft report at [6.36].

[133] HoustonKemp report on empirical evidence of grocery sector competition at [67]-[68].

and a number of smaller shops, whereas the other respondent may undertake one large shop of $200,

192.2 some respondents may have understood a question about "groceries" to be about how they shop for items at a supermarket as opposed to other retailers (e.g. a butcher), and

192.3 some respondents may have interpreted this question as the number of combined shopping trips that they undertake each week – i.e. some respondents may visit multiple grocery retailers during one outing, but class this as a "large shop".

193. The ambiguity of this question is demonstrated by respondents' answers to later questions in the survey. For example, one respondent selected that they tend to do at least one or two large shops each week only, but identified that in a typical week:[134]

193.1 they visit Countdown twice, spending a total of between $200 and $300 across those trips (i.e. an average of $100 to $150 per visit),

193.2 they visit a single-category or specialist grocer once, spending between $50 and $100, and

193.3 they shop with a meal kit provider once, spending between $100 and $200.

194. As a result, the responses to this question do not provide a reliable basis for concluding that most consumers carry out a main shop.

*The Commission's finding that most consumers purchase their main shop at one location and typically at a major retailer is not reliably supported by the evidence*

195. The Commission's conclusion at paragraph 4.85 is important and copied in full below (emphasis added):

> Despite submissions from the major grocery retailers on the decline of the main shopping mission, and the competitive format of the one-stop shop format, evidence from our consumer research suggests that most consumers **prefer** to buy groceries for their **main shop** at one grocery store and **typically from one of the major retailers**.

196. The Commission cites page 7 of the Ipsos report for this conclusion, but this page of the report does not support that conclusion. In particular, it notes:

196.1 "Participants... described a preference to shop for their grocery needs in a single store and location rather than visit multiple stores."

196.2 "Participants tended to avoid using multiple locations due to time constraints... However, very few reported purchasing their groceries only at supermarkets."

196.3 "Major supermarkets are the most popular destination for regular grocery shopping."

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[134] HoustonKemp report on empirical evidence of grocery sector competition at [69].

197. None of these statements say that consumers prefer to purchase their main shop at one of the major retailers.

198. The Commission then refers to the results of its consumer survey. It notes that 95% of respondents to the consumer survey reported one of the major grocery retailers as their main store.[135] However:

198.1 it would be wrong to assume that consumers selected a major grocery retailer as their main store because it reflected the characteristics of the defined "main shop" i.e. the convenience of getting all products in one location. That is not what the question asked; it only asked where consumers spend or buy the most, and

198.2 the results to the question simply suggest that most consumers can identify one store as being a place where they spend or buy the most. This may not necessarily be the store in which they undertake a main shop, but rather a store that they shop at more frequently. For example, a consumer who responded to the survey selected New World as their main store. However:

(a) the consumer visited New World six times per week spending a total of $300+ per week, and

(b) the consumer shopped at Countdown once per week, spending between $200-$300 in that one shop.

Therefore, it is likely that although this customer may spend more in total at New World, they undertake one large shop at Countdown and a number of smaller shops at New World.

198.3 It is unsurprising that consumers selected one of the major supermarkets as the place where they spend the most on groceries. But that tells us very little about competition: even if a major supermarket gets the largest portion of a consumer's spend, it begs the question how large is that part relative to their total spend, and where else does the consumer spend their money.

199. In short, the responses to this question do not allow the Commission to infer that most consumers carry out a main shop at a major retailer.

*The Commission's findings as to drivers of store choice are not reliably supported by its evidence*

200. The Commission finds that convenience and price are the main drivers for store choice.[136] As has been discussed above, by far the most important driver of store choice is convenience. That is not the convenience of having access to all products in one location (i.e. a main shop), rather it is convenience (ease) of location.

201. The Commission also uses the consumer survey results on drivers of store choice to support an analysis that drivers vary according to shopping mission.[137] The Commission does this by splitting the respondents into groups based on how they usually shop for groceries (i.e. the answer to question 4) and then estimating, for

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[135] Draft report at [4.87].

[136] Draft report at [2.5].

[137] Draft report, page 94.

each group, the proportion of respondents who selected each driver as their most important reason for store choice. Given that question 4 did not reflect the characteristics of a main shop (rather asking only about a "large" shop), analysing the survey answers in this way does not allow the Commission to form a view on drivers of store choice by mission type.[138]

202. Putting that to one side, the Commission finds that consumers who tend to do one or two larger shops a week are relatively more price sensitive than consumers who engage in more frequent shopping trips.[139] However, a close analysis of the consumer survey data demonstrates that the causal relationship is between price and consumers who choose PAK'nSAVE as a main store, not consumers who carry out large shops. For example, in total, 91% of respondents who selected low prices as the key driver of their main store, also selected PAK'nSAVE as their main store.[140]

203. This trend is clearly observable across the Commission's classifications of shopping behaviour, where above the vast majority of respondents who selected low prices as the main driver of store choice also selected PAK'nSAVE as their main store:[141]

203.1 one or two large shops a week: 93% of respondents,

203.2 one or two larger shops and a few smaller shops: 91% of respondents, and

203.3 several smaller shops: 90% of respondents.

204. The proportion of respondents who selected PAK'nSAVE as the main store differed between types of shopping behaviour. For example, of respondents who carry out several smaller shops, only 27% selected PAK'nSAVE as their main store.[142] By comparison, of respondents who carry out one or two large shops, 39% selected PAK'nSAVE as their main store.[143] As a result the higher proportion of PAK'nSAVE shoppers in the group carrying out one or two large shops is the reason for price being a relatively larger driver in store choice.[144]

205. Overall, this demonstrates that the causal relationship is between respondents choosing PAK'nSAVE as their main store and lower prices, not large (or main) shops and lower prices.[145]

***Criticisms of the consumer research***

206. Finally, FSSI considers that there are issues with the reliability of both surveys (some of which have already been alluded to above).

207. First, the Ipsos report was based on a very small sample (58 respondents only). While Ipsos asked participants to complete a questionnaire, the report largely presents qualitative research, based on interviews and small group discussions. As

[138] HoustonKemp report on empirical evidence of grocery sector competition at [101].

[139] Draft report at [4.77].

[140] HoustonKemp report on empirical evidence of grocery sector competition at [102].

[141] HoustonKemp report on empirical evidence of grocery sector competition at [102].

[142] HoustonKemp report on empirical evidence of grocery sector competition at [103].

[143] HoustonKemp report on empirical evidence of grocery sector competition at [103].

[144] HoustonKemp report on empirical evidence of grocery sector competition at [104].

[145] HoustonKemp report on empirical evidence of grocery sector competition at [105].

Ipsos acknowledges, there are a number of limitations of its approach, including that:[146]

207.1 the sample is not statistically representative of the New Zealand public's views (although Ipsos sought to include participants with a range of grocery shopping behaviours and attitudes), and

207.2 as with all qualitative research, the views presented in the report necessarily reflects those who participated in the study. The report is a descriptive summary of what participants expressed to Ipsos, but is not an exhaustive review of all experiences of New Zealanders within the grocery sector.

208. Second, the Commission's consumer survey was based on a very large sample (over 12,000 respondents). It is quantitative research. However, there are three particular issues with the survey form FSSI's perspective:

208.1 This was an online consumer survey hosted on the Commission's own website.[147] It was a self-invitation survey that had to be completed online. This makes the survey naturally biased towards those who are active online and were motivated to participate, as opposed to a scientific sample of participants that is a representative cross section of a population.

208.2 A natural consequence of that was that the consumer survey was not statistically representative. The Commission notes this,[148] but also concludes that the sample is "broadly consistent with key population demographics called by Statistics NZ".[149] One area where the sample was not consistent with underlying population demographics was in relation to age. In particular, age groups 41 and over were materially over-represented in the survey results and age groups 40 and below were materially under-represented. The significance of this has been addressed above.

208.3 The consumer survey did not include:

(a) in relation to food items: take-away food options, restaurants, markets, or liquor stores in its list of answers that respondents could select.[150]

(b) in relation to non-food items: pet stores and pharmacies.

FSSI considers that it competes with these participants for a range of different missions, and products.

209. While the results of the surveys should not be disregarded, their conclusions should be treated with caution, and corroborating evidence sought where possible.

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146 Ipsos report at [2.3].

147 Draft report at [F3].

148 "The results of the survey are unlikely to be truly representative of the underlying population of interest (ie grocery shoppers in New Zealand)": Draft report at [F27].

149 Draft report at [F48].

150 Draft report at [F35].

**Other retailers compete closely with the major retailers**

210. The Commission assesses the ability of other retailers to compete with the major retailers based on their ability to win the main shop. The Commission finds that other retailers are not able to, and do not, compete for the main shop. This enables the Commission to conclude that, in aggregate, other retailers do not constrain the major retailers. The market is accordingly characterised as a duopoly with a "fringe" of other retailers.[151] Further, the Commission considers that the future competitive environment is likely to remain relatively stable.[152]

211. The Commission's focus on the ability to compete for the main shop is misplaced. FSSI considers that it is constrained by other retailers. FSSI's key points are:

211.1 As set out above, FSSI's basket size and the Commission's consumer research are consistent with missions shopping. Therefore, the main shop should not be the sole basis on which competition is assessed – other shopping missions need to be included too.

211.2 FSSI faces intense competition from other retailers on those shopping missions. That competition directly affects the main shop: even if other retailers do not win the main shop, per se, they compete to effectively win parts of the main shop. That necessarily reduces the size of the main shop basket that major retailers may win.

211.3 As the Commission acknowledges, other retailers compete with the major retailers on QRS factors. This is good for consumers. In FSSI's experience, there is strong competition on price. But even then, the consumer survey results indicate that price is not the most important factor driving missions.

211.4 The full range of products is subject to at least one mission, and supermarkets cannot discriminate between consumers on different missions on price or other factors. This means that a response to a competitive constraint in respect of one mission benefits all consumers, including those doing a main shop. In that context, market shares for the main shop, considered independently, are not reflective of the reality of competition.[153]

211.5 Given the imminent entry of Costco, and potential entry and expansion of other competitors, the future competitive environment is not likely to remain stable; rather, the features summarised above will deepen and extend, and grocery markets will become more competitive.

212. Each of these arguments is developed in more detail below.

***All shopping missions are relevant to the assessment of competition***

213. The Commission has sought to assess the extent to which other grocery retailers compete with the major grocery retailers for consumers' main shop.[154] The focus of this assessment presumably arises from the Commission's earlier conclusions that most consumers regularly carry out a main shop from one supermarket and the

[151] Draft report at [5.95].

[152] Draft report, page 115.

[153] Draft report at [4.92]

[154] Draft report at [5.44].

major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.[155]

214. This submission has already addressed the lack of evidence for that conclusion. Instead, FSSI's sales data demonstrates that the majority of its sales, and the vast majority of its customers, relate to shopping missions other than the main shop. Further, the Commission's consumer research indicates that consumer shopping behaviour is consistent with missions shopping.

215. Given that, any assessment of the competitive constraint posed by other retailers needs to take into account their ability to constrain all shopping missions. Put another way, it would be quite wrong to focus solely on the ability of other retailers to constrain the main shop.

216. The Commission appears to accept that other retailers compete for the smaller shopping missions.[156] In FSSI's view, it faces intense competition from a range of other retailers across a range of shopping missions. Five examples of missions at both PAK'nSAVE and New World are set out below:

216.1 *The cooking from scratch mission.* Common basket items for that mission include meats, vegetables and tinned tomatoes and seasoning. PAK'nSAVE and New World compete for that mission with, for example, smaller specialist supermarkets (such as Kosco and Mediterranean Food Company), other retailers like butchers and greengrocers or farmers markets, meal kit providers, and online supermarkets (including produce delivery options). FSSI also competes with out of home options, such as Uber Eats, which provide an alternative to this mission.

216.2 *The breakfast mission.* Common basket items include yoghurt, fruit, cereal, bread and milk. Again, a range of other retailers compete for this mission, including specialist supermarkets, petrol stations, farmers' markets and meal kit providers, such as My Food Bag, which includes breakfast packs and fruit boxes and provides breakfast options through its "Kitchen" range. FSSI also competes with out of home options, including cafes, which provide an alternative to this mission.

216.3 *The beer and wine mission.* There are many other retailers competing for this mission including liquor stores, online retailers, and wineries or breweries through online purchases.

216.4 *The homecare and pet mission*. Common basket items include pet food, cleaning products, toilet paper and tissues, batteries and light bulbs. There are a range of retailers competing for this mission. For example:

(a) many household products can be purchased at general merchandisers, including online providers (e.g. the Warehouse and the Market), bulk stores or direct from the manufacturer (e.g. Ecostore cleaning products or EcoRoll toilet paper), and

(b) pet food can be purchased from vet clinics, speciality pet retailers (e.g. Animates,), online providers (e.g. Pet Direct, Pet Connect, Pet Post,

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[155] Market study into the retail grocery sector: Draft report - Executive summary at 4.

[156] Draft report at [4.59] and [5.54].

Feed My Furbaby) and rural supply retailers (e.g. Farm Source, Farmlands).

216.5 *The personal care and wellness mission*. Common basket items include baby formula, nappies, oral care, skin care, hair care, vitamins and personal wash products. These another highly competitive mission, with a wide range of retailers competing. For example, the following retailers compete for nappy sales: Kmart, the Warehouse, Chemist Warehouse, Bargain Chemist, online providers (nappies.co.nz) and the brands themselves (e.g. Huggies).

217. In other words, FSSI faces competition from a range of different retailers with a different competitive offering across the majority of its sales and the vast majority of its customers.

218. The Commission appears to cast this competition to one side in assessing the aggregate constraint other retailers impose, on the basis that it is not competition for the main shop. However, this is an overly simplistic way of assessing the effect of competition for other missions on competition for the main shop.

219. Competition is not simply a binary process of either "winning" the main shop, or not. Rather, it involves retailers:

219.1 first, competing to attract customers through the door, and

219.2 second, once customers are through the door, competing to secure the highest proportion of those customers' total grocery needs.

220. Viewed through that lens, major retailers compete with other retailers for the size and scope of regular main shop items. If a notional customer chooses to purchase particular grocery items on a separate mission from another retailer, then necessarily those items will not form part of that customer's main shop. Accordingly, the other retailer has won a portion of what otherwise would be a basket of goods purchased from a major retailer as part of the main shop.

221. To take an example, a material portion of a notional customer's weekly spend comprises products used to prepare dinner (i.e. the cooking from scratch mission). If that customer chooses to purchase a meal kit to fulfil this need, then the size and value of the basket of goods they need to purchase from a supermarket will necessarily be smaller.

222. The Commission notes that meal kits are not a substitute for supermarket shopping altogether.[157] FSSI agrees. However, meal kits are a substitute for a significant portion of the main shop basket. The evolution of My Food Bag to include breakfast and lunch options, as well as its August 2021 launch into pantry staples, means that it is well placed to win increasingly large portions of the main shop.

223. In fact, it is quite possible for consumers to purchase their grocery shopping needs without using a supermarket at all. There is a range of different retailers selling different parts of a consumer's basket, allowing the consumer to select the combination that best suits their preferences.

[157] Draft report at [5.68].

224. Therefore other retailers can and do compete with major retailers, not only for other missions, but for the size and scope of the main shop.

225. This is consistent with results from the consumer survey, canvassed above, which includes that:

225.1 75% of respondents visit two or more stores a week, with respondents visiting an average of 2.4 stores a week.[158] So the majority of consumers do not purchase all of their grocery needs from a single store.

225.2 40% of respondents visited a mix of major retailers and other retailers each week.[159] So, 40% of respondents split their weekly basket across major retailers and other retailers. This means that a number of consumers consider other grocery retailers as an alternative to major grocery retailers for items in their weekly basket.

225.3 The respondents who shopped at a mix of major retailers and other retailers spent an average of 24% of their weekly spend at other grocery retailers.[160] This means that, on average, consumers shopping at both the major retailers and other retailers, buy a quarter of their basket, by value, at other retailers.

***There is price and non-price competition between other retailers and the major grocery retailers***

226. The Commission finds that other retailers are not able to compete with the major retailers on price and therefore tend to compete by differentiating on QRS factors.[161] FSSI's key points in relation to this finding are that:

226.1 the Commission understates the extent of price competition between other retailers and FSSI,

226.2 there is intense competition on QRS factors and this benefits consumers. It is not correct that consumers value price competition above other forms of competition.

**There are national and local dimensions to price competition**

227. As the Commission acknowledges competition takes place on both national and local dimensions. In particular:

227.1 competition for specific missions takes place in local markets where consumers live and work, because consumers are willing to travel only limited distances to purchase groceries,[162] and

227.2 competition on pricing and promotions tends to take place on a national level – or in FSSI's case, at a South Island level. This reflects that FSSI sets a South Island maximum selling price (**MSP**), although stores are able to, and do, adjust prices to below the MSP in response to price competition.

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158 HoustonKemp report on empirical evidence of grocery sector competition at [107].

159 HoustonKemp report on empirical evidence of grocery sector competition at [108].

160 HoustonKemp report on empirical evidence of grocery sector competition at [109].

161 Draft report at [4.59] and [5.56].

162 Draft report at [4.28].

228. As the Commission acknowledges, the national and island-level component of competition is likely to be a bigger driver of prices charged at major grocery retailers' stores than competition in individual local markets.[163]

229. That is consistent with FSSI's view. FSSI primarily competes on price nationally through the setting of South Island MSPs and running island-wide promotions. FSSI considers that there is strong competition nationally on price and addresses this in detail at paragraph 258. FSSI agrees with the Commission that, provided there is strong national competition, this pricing strategy benefits consumers in markets where there is less local competition, who would otherwise pay higher prices.[164]

230. That is not to say that local price competition does not occur. FSSI makes the following observations:

230.1 First, it would be incorrect to say that the other retailers do not compete on price at all. There are degrees of price competition. The Commission acknowledges this in the draft report. For example, the Commission reports that:

230.2 most of the other grocery retailers the Commission spoke to said they monitor prices of similar products stocked at the major grocery retailer in close proximity to their own stores and that they make price adjustments accordingly to ensure that their prices are competitive,[165] and

230.3 in instances where other retailers compete on price they tend to focus on particular products or subsets of consumers, such as products stocked at international food stores or consumers who are willing to buy bulk goods.[166]

231. Second, FSSI understands that its Retail Stores compete with other retailers on price. The Commission observes that it has seen only ad hoc evidence of price comparisons done by the major retailers of the prices charged at other retailers and there was little evidence to suggest that these comparisons are done on an ongoing and consistent basis.[167] However, this reflects the reality that price competition with other retailers occurs mainly at store level, rather than Co-operative level, and therefore is not reflected in the information requested by the Commission from FSSI which was directed at a Co-operative level.

232. It is also supported by FSSI's observations of the conduct of individual store operators. For example FSSI is aware that individual members monitor, for example, prices charged by the Mad Butcher and have lowered prices in response to that competition.

233. The Commission also refers to the Frontier Economics report for the proposition that there is little evidence that the price charged by major grocery retailers in local markets was affected by:

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163 Draft report at [4.31] and [4.34].

164 Draft report at [4.33].

165 Draft report at [5.46].

166 Draft report at [5.57].

167 Draft report at [5.47].

233.1 proximity of other grocery retailers, such as specialist grocery retailers, international food stores and other supermarkets, and

233.2 local market concentration, including through entry and exit of other retailers.

234. These conclusions are simply consistent with the reality that FSSI primarily competes on price at a national level through the setting of a South Island wide MSP.[168] That being the case, changes in concentration in local markets, for example, through the presence of other retailers, would not be expected to have a significant effect on FSSI's local prices,[169] although members have the discretion to reduce prices at their stores in response to local competition.

235. FSSI notes that, in any event, it has reservations about the reliability of Frontier Economics' report given that Frontier Economics excluded from its analysis the prices of fresh fruit, vegetables and meat that were not packaged and identified with a brand name.[170] This is significant for two reasons:

235.1 as Frontier Economics note, some of the most obvious competitors for a supermarket are butchers and greengrocers.[171] Yet, Frontier Economics excluded the majority of products where competition between these retailers and supermarkets could be expected to be observed, and

235.2 promotions, and therefore price competition, are common across produce and, particularly, meat. This is consistent with the Commission's observation from its analysis of the major retailers' promotions that promotions were common across all three retailer banners for meat.[172]

236. This limits the reliability of Frontier Economics' results.[173]

***There is intense QRS competition between major grocery retailers and other retailers***

237. The Commission acknowledges that other retailers compete with major retailers on QRS dimensions. This is consistent with FSSI's experience, where it is constantly challenged by other retailers offering different ranges of products or different shopping experiences.

238. It is FSSI's experience that consumers can undertake shopping missions by category and as a result, FSSI banners compete for consumers who elect to shop at specialist retailers. Specialist retailers give consumers access to specialised or niche products, or a wider range of products than can be found in a supermarket along with specialist purchasing advice and in some instances bulk buying opportunities.

239. Competition from other retailers has meant FSSI expanding our meal solution offering in response to changing consumer preferences and competition. For example, instore made pizzas and take home hot meals. FSSI has a long record of

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168 HoustonKemp report on empirical evidence of grocery sector competition at [178].

169 HoustonKemp report on empirical evidence of grocery sector competition at [170].

170 Frontier Economics' report, page 10.

171 Frontier Economics' report, page 21.

172 Draft report at [7.52].

173 HoustonKemp report on empirical evidence of grocery sector competition at [159].

providing customer meal solutions, and is always developing its consumer offering. FSSI has also developed extensive offerings in evolving categories such as gluten free, keto, vegetarian, organic, free farmed, plant based, and vegan. In addition, FSSI has expanded its offering with respect to global cuisines (e.g. Mexican, Italian) which reflects the diverse nature of the customer and trends.

240. There are benefits to this QRS differentiation, especially in a non-homogenous product market. In particular, consumers benefit from having more choice to satisfy diverse needs and preferences.[174]

241. However, the Commission ultimately concludes that:[175]

241.1 product and service differentiation is a way for retailers to avoid directly competing on price,

241.2 many consumers told the Commission lower prices are the most important thing for them, and

241.3 price competition is an important feature of a workably competitive market.

242. As has been discussed above, the suggestion that the majority of consumers prefer competition on price is not supported by the empirical evidence. For example, in the consumer survey, when asked to select the most important reason for their choice in main store, only 15% of respondents chose low prices overall. In other words, 85% of respondents did not consider prices to be the driver of store choice.

243. At even more basic level, PAK'nSAVE is known throughout New Zealand for its brand promise of having New Zealand's lowest food prices and competes hard on that promise. Yet, every day, consumers choose to purchase the same products, at a higher price, from Countdown and New World. That must be because they prefer another part of Countdown's or New World's competitive offering i.e. the quality, range or service.

244. Therefore, there is no basis for the Commission to discount competition on QRS on the assumption that consumers prefer price competition.

245. Further, the Commission's analysis is generally inconsistent with economic theory, which holds that choice increases consumers' utility and is positive for a market.[176]

***A response to a competitive constraint on one mission benefits all missions***

246. The Commission finds that other retailers' QRS differentiation weakens potential competition with the major retailers because each tends to compete for consumers on different types of shopping missions.[177] FSSI disagrees with that proposition: a response to a competitive constraint on one mission benefits consumers on all shopping missions (even those engaged in a main shop) to the extent that the products overlap between those missions.

247. Competition between FSSI and another retailer on a particular shopping mission stands to benefit all consumers, even if they are engaged in a different shopping

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[174] Draft report at [5.59].

[175] Market study into the retail grocery sector: Draft report - Executive summary at 11.

[176] HoustonKemp report on empirical evidence of grocery sector competition at [425.

[177] Draft report at [5.59].

mission (and even if they are engaged in a main shop). This effect occurs because FSSI cannot possibly discriminate between customers according to the different types of shopping mission they may be engaged in. Therefore, if FSSI responds to a perceived competitive constraint it faces from another retailer on a smaller shopping mission, all consumers will benefit from that competitive response.

248. To take a practical example, in response to aggressive competition from meal kit providers, growing out of home consumption, and consumers' demand for convenience, FSSI has expanded its meal solution offer in stores. The benefit of this is available to all consumers. It is not limited to customers on the cooking from scratch mission or those who might have otherwise purchased a meal kit. Rather, it benefits all consumers, including main shop customers.

***The future outlook is not stable – Costco is entering the market and online grocery retailers are poised for growth***

249. The Commission concludes that the grocery retailing market has a stable outlook.[178] In FSSI's view, this ignores the effect that will be caused by Costco's imminent entry (as well as other features such as the threat of further entry and expansion), and the continuing expansion of online-only offerings. FSSI notes that Costco and online supermarkets offer the full range of grocery needs and therefore provide a main shop offering.

250. Costco plans to launch in Auckland in 2022 and has plans to open stores in Wellington and Christchurch at a later date having already secured a resource consent in Rolleston.[179] This would be consistent with its entry in, for example, Australia, where it has launched 12 stores since 2009.

251. [ ]:

251.1 Costco is a large multinational grocery retailer. It is the third largest retailer in the world by revenue and, as at December 2019, has 785 stores and has successfully launched into 12 different countries. It is therefore very well-resourced and has significant economies of scale. [ ].

251.2 [ ].[180]

251.3 [ ]:

(a) [

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178 Draft report at [5.22]-[5.26].

179 https://www.stuff.co.nz/business/industries/123230944/costco-delays-its-new-zealand-launch-but-is-actively-looking-for-additional-sites

180 [ ].

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(b) [ ].[181] [ ].

Further, its membership fees are affordable. For example, in Australia, a yearly membership costs AUD $60.[182]

252. [ ].

253. FSSI also considers that the draft report understates the effect of online grocery retailers. As the Commission acknowledges:

253.1 New Zealanders are increasingly opting to do their grocery shopping online, rather than in store,[183]

253.2 the COVID-19 pandemic has contributed significantly towards speeding up the growth of online shopping in New Zealand,[184]

253.3 in some countries overseas, up to 25% of grocery sales are made online,[185] and

253.4 it has not seen any evidence that New Zealand is different from other countries in terms of demand for online grocery services.[186]

254. In these circumstances, online grocery retailers are in a good position to expand sales and market share, and compete with the major retailers. This is particularly the case given online grocery retailers do not require physical sites to secure coverage to any particular local area.

255. In that context, FSSI reiterates the importance of assessing competition by reference to a forward looking position. By focussing on the main shop, the Commission has focussed on the past. There is a clear trend towards missions shopping, which is only expected to grow in the foreseeable future. As this trend grows, the prominence of online shopping, and indeed other retailers, will have increasing flow-on effects to the competitive landscape.

**The major retailers compete vigorously with each other**

256. The Commission finds that competition between the major grocery retailers is not effective because they differentiate their retail banners in ways that appear to limit

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[181] [ ].

[182] https://www.costco.com.au/membership

[183] Draft report at [3.147].

[184] Draft report at [3.149].

[185] Draft report, Figure 3.13.

[186] Draft report at [3.155].

competition between them, particularly on price.[187] The Commission says that the major retailers do this with the aim of attracting a more loyal and exclusive customer base.[188] FSSI notes that the evidence for this proposition is not apparent as it has been redacted from the draft report.

257. FSSI strongly disagrees with those propositions. In its view, competition between the major retailers is vigorous. As the Commission has identified, the major grocery retailers regularly monitor each other's prices, products and service offerings and adjust their offerings in order to remain competitive.[189] FSSI's key points are that:

257.1 there is vigorous competition between the major retailers on price,

257.2 there is vigorous competition between the major retailers on QRS, and this is a perfectly legitimate way of competing in a non-homogenous product market, and

257.3 the extent of consumer cross-shopping between the major retailers demonstrates that the major retailers are in competition with each other and have not effectively segmented the market.

***There is vigorous competition between the major retailers on price***

258. The importance of price competition should not be overstated: it is one means by which retailers may compete with each other, but there are other dimensions of competition too. In addition, as set out above, the results of the consumer survey do not establish that the majority of consumers prefer competition on price, rather than other factors.

259. In any event, FSSI considers that competition with Woolworths on price is intense. Price competition is a particular focus of FSSI's PAK'nSAVE banner, which has the brand promise of having New Zealand's lowest food prices. FSSI works hard to beat Woolworths on price and in particular to ensure that PAK'nSAVE delivers on its brand promise. This is consistent with the Commission's consumer research which, as noted above, confirmed that consumers who selected PAK'nSAVE as their main store view "low prices overall" as the key driver of store choice.

260. The Commission relies on Frontier Economics' analysis for its conclusion that price competition between the major retailers is less than it would expect in a workably competitive market. This conclusion is based on Frontier Economics' findings that local market concentration has little or no effect on price competition between the major retailers.

261. Again, the finding that local market concentration has little effect on price competition simply confirms that price competition between the major retailers takes place at a national level.[190] This is consistent with FSSI's price setting policy which occurs at a South Island wide level, and Woolworths price setting, which it says is almost entirely consistent nationwide.[191] When competition takes place at a

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[187] Draft report, page 111.

[188] Draft report at [5.110].

[189] Draft report at [5.103]-[5.104].

[190] HoustonKemp report on empirical evidence of grocery sector competition at [166].

[191] Draft report at [4.35].

national level, there is no reason to expect a change in local market concentration to have a significant effect on national or local prices.[192]

262. As such, the finding that local market concentration has limited effect on price competition between the major retailers does not have implications for the effectiveness of competition.[193] Rather, the Commission's own analysis of promotions and pass-through behaviour reinforces that price competition between the major retailers is strong.

263. First, the Commission notes that promotions are frequently offered on a significant proportion of products sold at New World, Countdown and PAK'nSAVE.[194] The Commission's analysis identified that, for example, in 2019:

263.1 approximately half of the major retailers' revenue came from products on promotion,[195] and

263.2 the discounts offered for in promotions were substantial, with the median discount varying between 16.8% and 24.4% depending on the type of promotion.[196]

264. This is consistent with FSSI's experience. It offers a range of promotions across each of its banners and seeks to ensure that its promotions are genuine and offer value to customers. This is a sign of strong and dynamic competition:[197]

264.1 it demonstrates that the major retailers are competing on price to win customers from each other. If competition was weak then the major retailers would not need to run these sorts of promotions,

264.2 it demonstrates that competition is dynamic because the major retailers offer different types of promotions, across a wide range of products, and

264.3 it is inconsistent with there being any coordination between the major retailers. In fact, the Commission concludes that the prevalence of discounts makes it difficult for firms to accommodate each other's conduct.[198]

265. The Commission's analysis of pricing correlations also supports a conclusion that price competition is strong. The Commission assessed five different geographic clusters, where there were two or more stores from different retail banners in relatively close proximity to each other. The Commission concluded that there was no obvious evidence of leader-follower type pricing across the stores in each of the five clusters.[199]

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192 HoustonKemp report on empirical evidence of grocery sector competition at [1636.

193 HoustonKemp report on empirical evidence of grocery sector competition at [165].

194 Draft report at [7.52].

195 Draft report at [E22].

196 Draft report, Figure E6.

197 HoustonKemp report on empirical evidence of grocery sector competition at [128].

198 Draft report at [5.140].

199 Draft report at [E40]-[E41].

266. The Commission noted that there was evidence that the pricing of some products was highly correlated across stores in a cluster, for example with alternating promotions. However, this was identified in respect of a very small proportion of goods, accounting for between eight and 29 of the top 1000 products by annual revenue and between 0.4% and 2.1% of store revenue.[200] This is not significant where the major retailers range tens of thousands of products. Finally, the Commission notes that despite the major retailers sharing a common set of suppliers, there was no evidence of:[201]

266.1 a "hub and spoke" agreement,

266.2 direct communications between retailers via common suppliers, with the aim of influencing each other's retail grocery offer, or

266.3 the major retailers having advance notice of each other's promotional schedules.

267. Second, the Commission analysed the extent to which the major retailers passed through increases in the COGS of at least 5% in 2019. The Commission's analysis on cost pass-through demonstrated that:[202]

267.1 Pass through of cost-changes is far from complete or consistent. For example:

(a) the median pass through for cost increases was between 8% and 75%,

(b) there were examples of negative pass through, where average prices changed in the opposite direction to average COGS. This occurred for between 19% and 32% of products which experienced cost increases, and

(c) there were examples of zero pass through, where the price of products remained the same before and after cost changes. This occurred for between 4% and 10% of products which experienced cost increases.

This reflects the dynamic and non-accommodating nature of price competition. If competition was weak, and the major retailers were unconstrained, then it could be expected that all cost-changes would be fully passed through to consumers.

267.2 There is substantially higher pass through of cost changes that affect both Foodstuffs and Woolworths, compared to changes that affect only one retailer.[203] This is consistent with strong competition between the major retailers, such that each is constrained by the other when only one of them faces an increase in costs. If competition was weak, then firms would be expected to pass-through cost increases whether or not that cost increase affected only one firm or both retailers.

[200] Draft report at [E42]-[E43].

[201] Draft report at [5.150]-[5.153].

[202] Draft report at [E45]-[E46].

[203] Draft report at [E50].

268. Finally, the Commission notes that its analysis suggests "a slightly stronger tendency for cost increases to be passed through compared to cost decreases".[204] As set out in HoustonKemp's report, the evidence does not allow that conclusion to be drawn. Among other reasons, HoustonKemp note that:[205]

268.1 The Commission says that the median pass-through for cost increases ranges from between 0% and 65% for cost decreases and 8% and 75% for cost increases. The median only provides the middle value. It is not possible to tell from this analysis:

(a) whether average cost pass-throughs for cost increases are higher than for cost decreases or not,

(b) the distribution of the cost pass-throughs from this analysis,

(c) the types of products where costs were passed through, or were not passed through, and whether those products were significant to consumers, or not.

268.2 The Commission's claim that there is a "slightly stronger tendency" for increases to be passed through, rather than decreases, is a weak claim, which the Commission does not state is statistically significant.

268.3 Grocery suppliers compete to provide a wide range of products, including on dimensions other than price. A reduction in COGS for a product may lead to a supermarket increasing the quality of stores, training its staff, or reducing the price of another product. This would still be effective competition.

***QRS differentiation reflects healthy competition***

269. Further, in FSSI's view, differentiation on QRS dimensions is an indicator of healthy competition. In competitive non-homogenous product markets it is perfectly legitimate (and common) for retailers to compete on QRS factors by, for example, offering a higher quality product or a different product range. It is equally legitimate for a retailer to compete on service, for example, by offering a superior in-store shopping experience for its customers. This sort of competition is to the ultimate benefit of consumers who have a diverse range of preferences. As the Commission acknowledges, some consumers might prefer lower prices and less differentiation on product range and quality,[206] and equally some consumers may prefer the inverse.

***Cross-shopping rates demonstrate intense competition between the major grocery retailers***

270. Finally, QRS differentiation does not, contrary to the Commission's findings, mean that the major retails win and capture the loyalty of a subset of customers. This is demonstrated by the extent of cross-shopping between the major retailers recorded in both the Commission's consumer survey and third-party consumer research.

271. The Commission reports that, based on the consumer survey, the majority of respondents viewed the major retailers as a closer alternative for each other than

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[204] Draft report at [E46].

[205] HoustonKemp report on empirical evidence of grocery sector competition at [132]-[147].

[206] Draft report at [5.108].

other grocery retailers.[207] The Commission does not report on what the consumer survey demonstrates about the extent of cross-shopping between the major retailers. HoustonKemp has analysed the responses to the consumer survey in its report. HoustonKemp's analysis demonstrates:[208]

271.1 respondents commonly shop across the large banners, with respondents shopping at an average of 1.7 large banners in a typically week, and

271.2 of the respondents who shop with at least one of Countdown, New World or PAK'nSAVE, approximately 46% shop only with one of those retailers. The remaining 54% shop at more than one of those retailers.

272. This view of cross shopping is also consistent with the Datamine Retailwatch reports that Foodstuffs receives, which are based on actual shopping transactions.[209] For example, the December 2020 report, which was based on nearly 35 million transactions recorded that nationally:[210]

272.1 Only [ ] of customers shopped at one of New World, PAK'nSAVE or the Countdown competitor group (including Countdown, Fresh Choice, Super Value, Farro Fresh, Bin Inn, Moore Wilson's and bakeries):

(a) the majority shopped only at the Countdown competitor group [ ],

(b) [ ] of consumers shopped only at New World, and

(c) [ ] of consumers shopped only at PAK'nSAVE.

272.2 [ ] of customers shopped at two or more of New World, PAK'nSAVE or the Countdown competitor group. And of those customers:

(a) [ ] shopped at New World and the Countdown competitor group,

(b) [ ] shopped at PAK'nSAVE and the Countdown competitor group,

(c) only [ ] shopped between New World and PAK'nSAVE, and

(d) [ ] shopped at all three retailers

273. This evidence does not support the Commission's finding that the major retailers' differentiation means that they segment the market between them. Rather, it suggests that the major retailers are competing with each other to attract customers, and consistent with this, the majority of consumers shop across the major retailers.

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[207] Draft report at [5.97]-[5.99].

[208] HoustonKemp report on empirical evidence of grocery sector competition at [116].

[209] [ ].

[210] [FSNI_68.3.10].

## CONDITIONS OF ENTRY AND EXPANSION

### FSSI's Key Points

274. In summary, FSSI's view is that:

274.1 the Commission's assessment of the conditions of entry and expansion needs to be adjusted, given the revised findings on profitability and competition, above. In particular:

(a) FSSI's profit levels would not in itself influence an overseas retailer to enter the New Zealand market and therefore have nothing to do with perceived barriers to entry,

(b) the Commission has understated the potential constraints imposed by entrants which deliver an offering less than the main shop on a nationwide basis, and

(c) the Commission has given insufficient weight to actual and potential constraints imposed by those retailers that offer a main shop,

274.2 availability of sites for big box retail is one factor which may affect entry and expansion of a traditional full-service network of supermarkets, noting that site availability issues are common across many jurisdictions and have not typically prevented entry by a range of players. FSSI is supportive of the Commission's recommendations to improve access to suitable supermarket sites,

274.3 New Zealand's size and geography are unlikely to be fatal to entry and expansion, but may well have an impact in the South Island, especially in rural areas,

274.4 consistent with the Commission's view, FSSI considers that a number of other conditions are unlikely to be materially hindering entry or expansion:

(a) MfN clauses, and similar contractual arrangements, and

(b) loyalty programmes, and

274.5 in addition, access to the cost advantages available to major retailers, and wholesale more generally, are unlikely to be hindering the type of entry of expansion the Commission is focused on.

### *Revised findings on profitability and competition require changes to entry and expansion analysis*

275. The Commission's approach to the conditions of entry and expansion was predicated on a number of key findings on profitability and the nature of the competition. In particular, the Commission's assessment of entry and expansion was influenced by its findings that:

275.1 FSSI (and the other major retailers) earned excess returns, and

275.2 most consumers preferred to buy their groceries by way of a weekly main shop.

*Profitability*

276. The analysis above demonstrates that both findings are not supported by the evidence. This has flow on effects to the Commission's analysis of the conditions of entry and expansion.

277. As regards profitability, the evidence demonstrates that FSSI's level of profitability is consistent with workable competition. It is therefore not possible to conclude that high profitability, coupled with the lack of recent large-scale entry, demonstrates that conditions of entry and expansion are limiting the scope for effective competition.[211] Rather, it may be that there has been relatively less entry by overseas retailers because the expected returns are not significantly better than those that could be earned overseas.

*Consumer shopping behaviour*

278 As regards consumer shopping behaviour, as discussed in "the nature of competition" section of this submission, the evidence before the Commission demonstrates that:

278.1 consumer shopping behaviour is aligned with all the key features of missions shopping i.e. more frequent, smaller shops. As such, the main shop is no longer the key feature of competition for the supply of groceries at retail, and

278.2 FSSI competes closely with many other retailers for all missions other than the main shop, and for the size and scope of the main shop i.e. there is strong competition with other retailers to attract customers and then secure as large a proportion of the main shop as possible.

279 Accordingly, FSSI invites the Commission to reassess its preliminary decision to "particularly focus on entry and expansion conditions relating to the ability of new entrants or existing firms to compete with the major grocery retailers for the provision of a main shop".[212]

*Constraints imposed by other grocery retailers competing for other missions*

280. FSSI believes that it is the ability of entrants operating across the *full* spectrum of business models competing for all shopping missions (and not just the provision of a full shop) to enter/and or expand that is critical to the levels of competition in *relevant* grocery markets. As the analysis above demonstrates, FSSI regularly competes with these other retailers for each mission, and for the size of the main shop basket.

281. The reduced impact of conditions of entry and expansion on different business models is acknowledged by the Commission. Further, the fact that any barriers can be overcome is unequivocally demonstrated by the numerous examples provided to the Commission and discussed by the Commission in the draft report (for example at paragraph 6.27).

282. Critically, the pace of such entry and expansion has been increasing in recent years. Given alignment with technological and demographic trends there is no reason to believe that this growth will not continue into the foreseeable future.

[211] Draft report at [6.26].

[212] Draft report at [6.23].

*Constraints imposed by other grocery retailers competing for the main shop*

283. The Commission has also understated the constraint that will be imposed by entry and expansion of retailers whose model incorporates the provision of a main order shop.

284. In particular, with regard to the entry and expansion of Costco, as discussed in paragraphs 249 to 252, FSSI considers that [ ]. With its different business model and international scale, Costco appears to have disruptive/maverick characteristics and is accordingly likely to have a substantial impact both in applicable local markets and nationally.[213]

285. With regard to the potential impact of the growth of online grocery offerings, current penetrations and historic growth rates are unlikely to be accurate predictors of future impact (as demonstrated in multiple circumstances throughout the history of the internet and having regard to the exponential growth of online shopping generally).

***Site availability and development may affect entry and expansion***

286. FSSI agrees that availability of sites for big box retail is one factor which may affect entry and expansion of a traditional full-service network of supermarkets. As discussed in its submission on the Commission's potential options for recommendations below, FSSI is supportive of the Commission's recommendations to improve access to suitable supermarket sites.

287. As well as giving competition factors greater prominence in planning proceedings, FSSI believes there is scope for the Commission and ultimately the Government to consider other regulatory hurdles to parties acquiring land such as planning laws which generally reduce the supply of appropriate land as well as the Overseas Investment Act 2005. For example, wrongly categorising land as 'sensitive land' under that Act may result in potential overseas entrants missing out on the opportunity to acquire supermarket sites due to onerous and time-consuming consent processes.

288. As an overriding caution however, FSSI warns against giving site availability issues inappropriate prominence in the Commission's analysis and ultimate recommendations. This is because:

288.1 big box retailers including grocery retailers (such as WWL, FSNI, FSSI and Costco) have overcome the relevant challenges and acquired sites on a consistent basis;

288.2 site availability is a common issue in many jurisdictions, but this has not prevented entry by a range of players including largescale supermarket players; and

288.3 the analysis needs to recognise that competition for store locations is, in itself, an important feature of the retail supply of groceries. Decisions involve the commitment of significant capital and the taking of substantial risks.

[213] It is noteworthy that an important feature of the Commission's reasoning in Decision Nos. 606 & 607 (Warehouse decisions) was the potential for the Warehouse Extra to play the role of a maverick in relevant grocery markets (due to its ability to take advantage of the so-called 'halo effect').

**Impact of New Zealand's size and geography**

289. FSSI agrees with the Commission's conclusion in paragraph 6.54 that New Zealand's size and geography is not necessarily fatal to the viability of material market entry and/or expansion.

290. However, New Zealand's size and geography, and in particular the South Island, will have an impact on the viability of entry and expansion at the full-service nationwide supermarket end of the spectrum especially in rural areas.

291. We note that such factors have not deterred Costco and other 'Big Box' retailers from entering the New Zealand market.

**Other conditions are unlikely to inhibit entry or expansion**

292. FSSI considers that the other factors noted by the Commission are unlikely to inhibit entry and expansion.

***Conduct by suppliers and retailers affecting product sourcing***

293. As recognised by the Commission, the alleged conduct by suppliers described by the Commission in paragraphs 6.161 to 6.176 of the draft report may breach the existing provisions of the Commerce Act. FSSI has no evidence that it or its members have been party to this type of conduct. With regard to MFN or other similar contractual arrangements with its suppliers, FSSI does not as a general rule seek to insert these clauses in its supply agreements. Currently, we have only two agreements with such clauses. Like the Commission, FSSI agrees that such arrangements are unlikely to have a significant impact on entry and expansion in the retail grocery sector.

***Loyalty programmes***

294. We agree with the Commission that loyalty programmes do not represent a material constraint on entry or expansion.

***Cost advantages available to the major grocery retailers***

295. As acknowledged by the Commission, the presence of local scale and associated cost advantages to the incumbent major grocery retailers is not unique to New Zealand nor is in itself a competition problem.

296. Evidence from both New Zealand and overseas is that new grocery entrants simply adopt a range of different strategies to overcome these advantages including focussing on different aspects of the PQRS spectrum (i.e. product differentiation), and innovation (i.e. the hypermarket concept). The ability of global retailers to draw upon overseas scale/purchasing power for key items should also not be overlooked (Costco is a prime example of this).

297. These issues are discussed further in the context of the need for access to wholesale products.

***Access to wholesale***

298. This topic is discussed in FSSI's submission on the Commission's potential options for recommendations below. As noted, it is extremely unlikely that any substantial new entrant would require access to products at wholesale in order to enter relevant markets successfully.

## ACQUISITION OF GROCERIES BY RETAILERS

### FSSI's Key Points

299. As explained in further detail below, FSSI is supportive of a grocery code focussed on improving outcomes for consumers. However, FSSI considers that a number of factors need to borne in mind when considering the interactions between retailers and suppliers and the flow on effects for consumers. FSSI's key points on that topic are:

299.1 as acknowledged by the Commission, there are limitations in the information the Commission had available to it on the interactions between retailers and suppliers,

299.2 FSSI values its supplier relationships. Those relationships are generally positive and constructive, noting that FSSI is committed to working with suppliers, organisations such as the New Zealand Food and Grocery Council (**FGC**) and the Commission to address any issues which fall outside the usual expected robust bargaining processes,

299.3 many key product categories are concentrated on the supply-side and suppliers have material bargaining power. While FSSI has in excess 1,000 suppliers, a much smaller number of suppliers manufacture the products that comprise the majority of FSSI's sales,

299.4 as regards the Commission's examples of conduct arising from buyer power:

(a) bargaining can be complex and flexibility is required, but FSSI considers that current common commercial terms generally reflect appropriate and efficient risk allocation for the context in which they are agreed,

(b) FSSI has no interest in promoting reduced transparency over price and non-price terms of supply, and

(c) FSSI does not consider there is evidence to support a finding that it anti-competitively limits the terms on which suppliers may supply other retailers,

299.5 the Commission's cost pass-through analysis demonstrates that major retailers' cost-pass through behaviour is consistent with workable competition, and

299.6 private label is pro-competitive and provides value to customers.

### There are limitations in the information available to the Commission on interactions between retailers and suppliers

300. As acknowledged by the Commission at the opening paragraphs of chapter 8 of its draft report:

300.1 its preliminary views expressed in the chapter are based on the opinions and perceptions of retailers and suppliers;

300.2 the vast bulk of evidence is anecdotal (from suppliers and their representative bodies);

300.3 the Commission has not considered the circumstances or commercial rationale of each party underlying the behaviour ascribed to it; and

300.4 it is challenging to find direct evidence of how interactions between retailers and suppliers affect outcomes for consumers.

301. Furthermore, as far as FSSI is aware, the Commission has not undertaken any analysis of supplier margins or considered the actual state of competition in the relevant upstream markets alleged to have been impacted by the interactions between retailers and suppliers. [214]

302. Given these acknowledged limitations, FSSI's view is that the work undertaken to date in the study is not sufficient to properly conclude that "competition is not working well for suppliers" and more specifically that "retailers are exercising buyer power in ways that are likely to ultimately harm consumers". In FSSI's view, to reach these conclusions with sufficient certainty (including to form a basis for regulatory intervention) would require significantly more evidence and analysis including analysis of supplier margins.

**FSSI's relationship with suppliers**

303. The draft report sets out a range of experiences suppliers describe when dealing with the major grocery retailers. The results of the 2020 Nielsen Barometer supplier sentiment survey undertaken by NielsenIQ noted in the draft report, also provide a snapshot of current supplier sentiment. This survey, undertaken yearly, is an independent supplier survey that measures supplier sentiment on a range of experiences when dealing with the major grocery retailers. In 2020 the Neilsen Barometer Survey was completed by 112 suppliers across New Zealand

304. FSSI reviews the results of the yearly Retail Barometer supplier sentiment survey. The Barometer results presented by NielsenIQ are then dispersed across the FSSI business, for the cooperative to accurately monitor the level of supplier sentiment against our industry. The results of this survey are accepted as a key performance indicator of our business relationship with suppliers and are reported to our Board.

305. NielsenIQ provided FSSI with a summary report on its performance for the period 2016 to 2020. The data showed:

305.1 75% of suppliers to FSSI have rated their overall trading relationship with FSSI as Good or Excellent in 2020, this was 73% in 2016,

305.2 92% of suppliers to FSSI have rated FSSI as Good or Excellent in 2020 in terms of being respectful in their day to day business relationship, this was 89% in 2016, and

305.3 87% of suppliers to FSSI have rated FSSI as Good or Excellent in 2020 in terms of delivering on promises in their day to day business relationship, this was 82% in 2016.[215]

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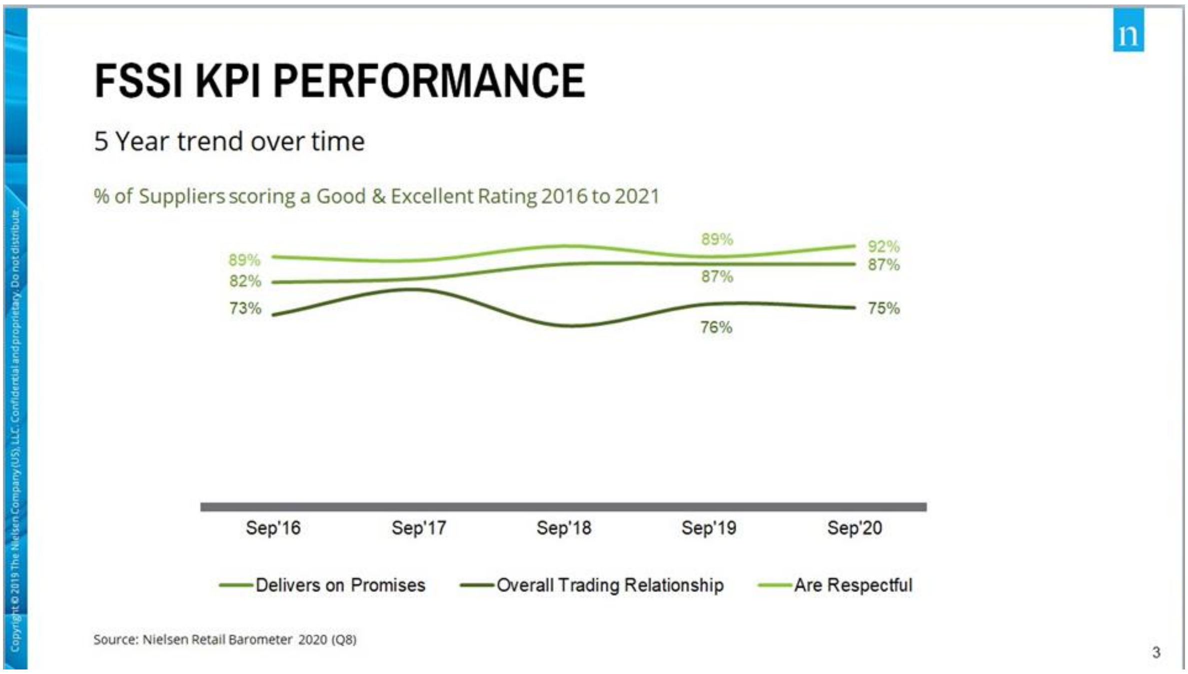
[214] It is noteworthy that for a typical item sold by FSSI, for every $1, around 67c of that dollar relates to the cost at the supplier level.

[215] FSSI calculation based in part on data reported by NielsenIQ through its Retail Barometer supplier sentiment survey for 2020 including data from the 2016 – 2020 surveys inclusive. Copyright © 2021, A.C.Nielsen (N.Z.) ULC.

306. The graph below represents FSSI KPI performance of the last 5 years in the key areas of its business trading relationship with the supplier community




307. FSSI wishes to reiterate the value it places on its supplier relationships and the multi layered and valuable relationships the Co-operative and its Members have developed with suppliers, some spanning many decades.

308. FSSI conducts business with its supplier partners in accordance with the Foodstuffs Supplier Charter. This charter outlines our Principles, our expectations, our commitments and our conflict/dispute resolution process.

**Presence of buyer power/countervailing market power**

309. The Commission acknowledges that:

309.1 some suppliers have countervailing market power, and

309.2 there are a range of factors which would potentially improve the negotiating position of suppliers including the ability to export, the availability of other domestic sales channels, brand strength and the number of suppliers in a product category.

310. However, the Commission then reaches the preliminary view that 'in most cases there appears to be an imbalance of bargaining power in favour of the major grocery retailers'. The extent of this imbalance then colours/forms the basis of the analysis that follows regarding use of buyer power and ultimately potential harm to consumers.

311. As noted by the Commission, the major grocery retailers have thousands of suppliers. However, the bulk of groceries purchased by consumers on a regular basis is from a much smaller group of suppliers where the relevant upstream market is more concentrated and there is a higher degree of countervailing market power. For example, across FSSI's total grocery sales in the 13 weeks ending on 8 August 2021, 25% of sales were attributable to 11 of New Zealand's biggest suppliers and 90% of sales came from just 198 suppliers (with an additional 1,632 suppliers

making up the last 10% of sales). Key categories where there is high concentration include:

311.1 fresh milk (two key suppliers),

311.2 yoghurt (two key suppliers),

311.3 carbonated beverages (two key suppliers),

311.4 bread (two key suppliers),

311.5 biscuits (three key suppliers),

311.6 beer (two key suppliers),

311.7 pet food (two key suppliers),

311.8 confectionery (two key suppliers), and

311.9 chips (two key suppliers).

312. FSSI's view is that:

312.1 in assessing the extent of buyer power issues and associated concerns, the Commission's analysis should have regard to/give appropriate weighting to the relative volume/value of different product categories purchased by New Zealand consumers (including as part of a main shop),

312.2 bargaining and buyer power cannot properly be assessed/understood without a more comprehensive analysis of interactions between suppliers and retailers including an analysis of supplier margins and pricing behaviour,

312.3 the absence of examples of written variations to legal supply terms is more indicative of industry culture/practices rather than any indication of buyer power,

312.4 while the position of suppliers of perishable products does differ from packed goods, it is nevertheless noteworthy that these suppliers are more likely to have other options available to them including export or food services, and

312.5 more generally, the prominence given by the Commission in its draft report to the main shop gives inappropriate weight to the alternatives available for suppliers in terms of alternative buyers who provide less than a main order shop.[216]

313. The above views should not be read as FSSI failing to acknowledge any particular supplier that has experienced conduct which is unlawful or falls outside acceptable commercial norms (or seeking to minimise the potential harm from such conduct). Regarding paragraphs 9.113-9.127 of the Draft Report, FSSI is generally supportive

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[216] Also, the Commission appears to place some weight on the responses from suppliers when asked how they would fare if the major grocery retailers they supplied were no longer able or willing to stock their products (in their entirety). In the context of complex bilateral negotiating frameworks, FSSI queries how helpful this question (with its focus on an extreme scenario) is to assess the strength or otherwise of suppliers' actual countervailing market power.

of a well-considered grocery code that addresses such conduct (with a focus on the benefits to consumers). However, FSSI believes it is critical that:

313.1 these issues are brought to the fore when considering aspects of any proposed intervention which effectively amount to regulating the commercial terms on which suppliers and grocery retailers interact, and

313.2 the specific concerns raised by the Commission (discussed below) are viewed in light of the issues raised.

**FSSI's response to specific concerns raised by the Commission**

314. FSSI now responds to the specific concerns raised by the Commission in the draft report regarding:

314.1 transfer of costs and risks from retailers to suppliers,

314.2 lack of transparency over supply terms, and

314.3 limiting supply terms to other retailers.

***Transfer of costs and risks from retailers to suppliers***

315. FSSI agrees that appropriate and efficient allocation of risks is an important feature of arrangements between grocery retailers and suppliers. As a matter of principle, FSSI's view is that to cater for the complex and multi-layered bargaining framework, flexibility is needed (rather than a one size fits all approach to the relevant issues).

315.1 [

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315.2 In these circumstances, FSSI stores may forward buy products (with the consent of the supplier) at the promotion cost price to enable stores to offer value to customers over a period longer than the specific promotion.

315.3 Forward buying:

(a) enables suppliers to discount the cost price of product and incentivises stores to purchase high volumes of product and promote instore, and

(b) can be used by suppliers to achieve sales targets, move older stock, sell through stock in advance of a new product being launched and provide working capital.

315.4 [

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315.5 [ ]:

(a) [ ],

(b) [ ], and

(c) [ ].

316. With regard to shrinkage and wastage, in 2007 FSSI, in consultation and with the support of suppliers, introduced a Damaged Product Allowance (**DPA**) solution to assist both our suppliers and banner group stores to manage more efficiently all damaged products or those with minor manufacturing faults. DPA was introduced to remove the costs associated with many small one-off claims – it doesn't preclude claims relating to major manufacturing faults.

***Lack of transparency over terms of supply***

317. FSSI has no interest in promoting reduced transparency over price and non-price terms of supply (noting the Commission's concern that such conduct places undue uncertainty on suppliers). As discussed previously, FSSI sees the lack of formal contracts and documentation as more of an indication of how things have evolved in the sector rather than any deliberate strategy to misuse market power.

318. With regard to the issue of deletions, it is important that the Commission understands that:

318.1 ranging decisions and assessments are constantly being made (albeit endeavouring to ensure that these decisions are made transparently in accordance with documented processes and policies), and

318.2 given the finite shelf space and the very significant pipeline of new products being developed, deletion decisions are made from time to time even where products are not poorly performing and often with input from suppliers.

***Limiting supply terms to other retailers***

319. FSSI's position is that while it negotiates vigorously with suppliers and expects favourable terms which reflect volumes supplied and reflects the prices that FSSI sees in the market, it does not generally seek to limit the terms on which suppliers may supply other retailers.

320. FSSI forms strategic relationships with suppliers to provide exclusive arrangements around controlled label branded product supply. FSSI will work with a supplier to maximise an opportunity by committing to a volume forecast and a new product development program to provide innovation to our consumers.

321. FSSI has no evidence to suggest that it or its members are involved in the type of conduct described in relation to any new entrants such as the Honest Grocer (and it would have no tolerance for such conduct).

**The Commission's pass through analysis demonstrates that competition is working well consumers**

322. FSSI's position is also that harm to consumers is only likely to arise from any presence of buyer power where:

322.1 profits generally made by supermarkets are substantially and sustainably above the competitive level, and

322.2 cost savings achieved in the form of better terms with suppliers for particular items are not passed through.

323. However:

323.1 profits are not different from the competitive level – as indicated by the Commission's international sample of grocery retailers, and

323.2 the evidence is that sector-wide cost changes are passed through to consumers consistent with workable competition.

324. As acknowledged by the Commission, any buyer power will benefit consumers if better purchasing terms flow through to lower prices or other benefits.

325. As discussed in its submission on the nature of competition in the retail grocery sector above, FSSI's view is that the retail market is vigorously competitive, allaying any concerns that favourable purchasing terms or other benefits will not be passed on to consumers.

326. Further, the Commission's conclusion that there is limited evidence of retailers passing through cost reductions to consumers is not supported by its analysis in Appendix E. As set out in HoustonKemp's report, and discussed above, the Commission's analysis in Appendix E shows that pass through: [217]

326.1 is far from complete, which likely reflects the intensity of competition and therefore the inability of individual competitors to pass through firm-specific cost changes,

326.2 appears not to be significantly different between increases and decreases (no statistical significance is claimed by the Commission for the observed difference), and

326.3 is substantially higher for cost changes that affect both retailers, compared to changes that affect only one retailer.

327. Overall, as set out earlier in this submission, this evidence is consistent with strong competition between the major retailers, in the following ways:

327.1 frequent and wide-spread pricing promotions are a sign of dynamic, intensive competition;

327.2 pass through of cost changes is far from complete or consistent, which likely reflects the dynamic, non-accommodating nature of price competition; and

327.3 sector-wide pass through is much more complete or consistent, which is what would be expected under intensive, effective competition.

[217] HoustonKemp report on empirical evidence of grocery sector competition at [136]-[147].

**Private label is pro-competitive**

328. FSSI notes that the Commission is unclear as to the overall impact of private label in New Zealand, and reiterates its views that:

328.1 development and supply of private label products enhances competition at the supplier level,

328.2 it is an important way in which FSSI responds to the market power of major global and domestic suppliers including those identified in paragraph 311 above,

328.3 FSSI's private label is an important source of innovation, including to provide value to customers through new product offerings. Recent examples of this include the launch of Pams plant based and Pams finest range, and

328.4 private label gives retailers greater influence over the supply chain with associated benefits for security of supply and ability to meet variable customer demand, as has been particularly evidenced in the COVID-19 environment.

329. Private label also provides valuable volumes which underpin and enhance local manufacturing capacity. FSSI notes that approximately 70% of its private label products are locally manufactured.

**THE COMMISSION'S OPTIONS FOR RECOMMENDATIONS**

330. FSSI's position on each of the Commission's options for recommendations is summarised in brief below:

330.1 Access to wholesale – FSSI considers that facilitating access for other retailers to its product and distribution network (which the Commission refers to as FSSI's wholesale business) and whether regulated or not, creates a number of difficulties that need to be worked through. FSSI opposes operational or structural separation of the FSSI Co-operative from the retail stores.

330.2 Improving access to suitable sites – while there is some detail to be worked through, FSSI is supportive of measures to improve access to suitable sites.

330.3 Options to directly improve retail competition – FSSI does not consider it appropriate to comment on whether the Government should sponsor a new entrant, but raises some questions regarding efforts to directly improve retail competition in whatever form. Costco is due to enter the retail market next year and [ ].

330.4 Options to improve competition for the acquisition of goods – FSSI is not opposed to a well-considered grocery code which deals with matters which are objectively unacceptable or outside commercial norms. FSSI's view is that the market study is not the appropriate forum to determine the content of the code which needs to be the subject of significant work and consultation to ensure that it is to the benefit of consumers. FSSI does not support collective bargaining, on the basis that it is not required and is likely to result in detriments to consumers due to the inefficiencies created and reduction in competition in relevant markets.

330.5 Options for improving the information provided to consumers – FSSI agrees that current practises regarding promotions, unit pricing and loyalty terms and conditions could be improved. FSSI puts forward a number of suggestion for how these improvements could be made.

**ACCESS TO PRODUCTS AT THE WHOLESALE LEVEL**

**FSSI's key points**

331. The Commission finds that the absence of an independent grocery wholesaler supplying many products on competitive terms may limit the ability of existing retailers and new entrants to obtain the full range of competitively priced grocery products needed to compete with the major grocery retailers.[218] As a result, the Commission identifies several options for recommendations for improving access to products at wholesale.

332. FSSI makes three overarching points:

332.1 most importantly, even assuming the Commission's draft findings about deficiencies in competition in grocery markets are correct, it is not clear that improving access to products at the wholesale level would have the potential to address these deficiencies because:

(a) access to a functioning wholesale market is unlikely to be utilised by a large new entrant. This is the type of competitor the Commission considers would address its competition concerns,

(b) it is questionable whether access to the wholesale market would, on the Commission's analysis, materially help any other retailers (or new entrant retailers) to compete with the major retailers,

(c) it is far from clear that, even if market participants did take advantage of the wholesale supply, the competitive alternative they would present would be meaningful from consumers' perspective, and

332.2 the recommendations raise a range of practical issues, some highly complex. In the short time available, it has not been possible for FSSI to work through all of these issues. As such, FSSI has focused on identifying issues that would need to be considered and worked through before recommendations about wholesale access (if any) could be firmed up. For example, 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 operational or structural separation.

332.3 In this regard, it is critical to bear in mind that the Commission's recommendations are preliminary and, even at the final report stage, will not have been exposed to a policy process and in particular subjected to any cost-benefit analysis.[219]

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[218] Draft report at [9.33].

[219] Draft report at [9.4].

**Improving access to wholesale does not appear to have the potential to stimulate the kind of retail competition the Commission wants to achieve for Consumers**

333. As has been explained above, FSSI competes strongly with other retailers for the full range of missions and the size and scope of the main shop. As such, FSSI considers that competition is effective and other retailers do not require access to wholesale to be able to compete with it.

334. Further, FSSI considers that regulating wholesale grocery access would not have the potential to stimulate the kind of competition the Commission wants to achieve in retail grocery markets.

335. First, access to a functioning wholesale market is very unlikely to be utilised by a large new entrant. The Commission's view seems to be that only a large new entrant, with an island wide, or national, presence, will be able to compete with the major retailers for the main shop.[220] It is extremely unlikely that such a new entrant would require access to products at wholesale in order to enter successfully. Rather, such a new entrant would be far more likely to compete on a vertically integrated basis. This view is consistent with:

335.1 the Commission's recognition that Aldi's method of entry typically involves entering both retail and wholesale levels, and building a number of stores (usually 10) as well as distribution centres to service its stores,[221]

335.2 Costco's imminent entry. FSSI understands that Costco will adopt a direct supply model, rather than involving a wholesaler, and

335.3 generally, the business structures of most of the Commission's international sample of grocery retailers.

336. Secondly, it is questionable whether access to wholesale supply would, on the Commission's analysis, materially help other retailers (or new entrant retailers of a similar size to these retailers) to compete with the major retailers. In that regard, the Commission:

336.1 acknowledges that international food stores, meal kit providers and some specialist grocery retailers sell products in categories where there is already effective wholesale (e.g. fresh produce).[222] As a result, these sorts of retailers would not stand to benefit significantly from regulated access to wholesale, and

336.2 takes the view that grocery retailers that do not sell a significant volume of groceries, such as convenience stores and dairies, would benefit from access to wholesale.[223] However, in any event, it is unlikely that entry and expansion of such retailers would, on the Commission's view of the world, be able to increase the level of retail competition. The Commission considers that retail competition is only enhanced by competition for the main shop increasing. That in turn, on the Commission's definition, requires a retailer to stock a full range of products to allow consumers to purchase all their grocery needs in a

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220 Draft report at bullet point 1 of the Chapter 5 summary and [6.24].

221 Draft report at [6.157].

222 Draft report at [6.139.2].

223 Draft report at [6.139.3].

single store. Given the typical size of convenience stores and dairies it would simply not be possible for them to stock the range of products required to compete for the main shop. It is not clear whether such retailers would make use of an additional source of wholesale supply but, even if they did, this would not address the Commission's concerns.

337. There is therefore a misalignment between the problem identified by the Commission and the remedy suggested.

338. Finally, the Commission may be suggesting access to wholesale not only to provide a "ladder" to vertically integrated competition, but as an ongoing solution whereby retail dynamics would effectively "mimic" the operation of markets with a greater number of participants. Again, to discuss this point, FSSI sets aside the evidence it presents above, which demonstrates that workable competition already exists.

339. It is not clear that wholesale access would provide a meaningful outcome from this perspective either, partly for the reasons given above. In addition, market participants taking wholesale supply would effectively be operating with an identical cost base to one of the major grocery retailers (noting that, as above, for FSSI supplier costs alone constitute approximately 67% of shelf price) and would presumably also be restricted in some way to FSSI's range. As such, the competition those market participants would present would be limited to undercutting FSSI's prices based on very slight differences in retail costs, or based on differentiated services for the same product range and similar prices. It is not clear to FSSI that this would constitute meaningful competition from a consumer perspective (particularly when compared with the costs and difficulties that would likely arise from implementation, as outlined in the following sections). It would also be unlikely to facilitate the type of competition that the Commission appears most interested in facilitating i.e. price competition.

**Options to improve supply through existing wholesale grocery channels are complex**

340. The Commission has proposed several options for regulating access to existing wholesale grocery channels. A comparison with other regulated wholesale markets has enabled FSSI to expose some preliminary issues associated with these proposals, which would need to be worked through.

341. It is clear that regulating existing wholesale grocery channels (and any grocery wholesale market) would be highly complex. There are a wide range of implementation challenges that the Commission, and industry, would need to consider and resolve.

***Regulating access to a large number of non-homogenous products would be complex***

342. Both fuel and milk are homogenous product markets, with regulation applying in respect of a small number of relatively undifferentiated products and focusing on access to, and the price of, the specific regulated product (fuels, milk).

343. By comparison, the grocery market involves a large and complex range of branded and differentiated products. That is:

343.1 there are constant variations in product range and price. For example, in 2020 FSSI:

(a) ranged 82,473 products across PAK'nSAVE, New World, Four Square and Trents,

(b) discontinued approximately 3,900 products,

(c) introduced approximately 8,800 new products,

(d) handled approximately 26,000 different products through its Distribution Centres and cash and carry operations, and

(e) processed approximately 39,000 product cost price changes (excluding promotional price changes),[224]

343.2 the same type of product can be differentiated significantly both by price, quality and quantity. For example, for any given grocery product, there are different brands available and different package sizes, with different prices accordingly, and

343.3 product selection, or ranging, involves important decisions about competitive positioning, rather than all retailers providing a similar offering with the product range remaining broadly constant.

344. The Commission has recognised that the large number of products sold in the grocery market means price regulation would likely be costly and difficult. Foodstuffs' preliminary reactions are:

344.1 regulatory requirements would need to accommodate a very large number and complexity of products, compared with fuel and dairy. In both fuel and dairy it was practically possible to establish "must supply" obligations[225] and an "open entry and exit" regime.[226] The Commission has recommended that regulated access to existing grocery wholesale channels include obligations to provide supply to any member of a class of business.[227] While open access approaches work for fuel and dairy, their application to a market such as groceries is far more complex. For example, does the regulated wholesaler need to provide access to all products, which include private label products developed by the supermarkets, or only a defined class,

344.2 consideration would need to be given to how product selection would be affected by obligations in relation to wholesale supply. For example, the Commission canvasses, "an obligation to publish, or to provide on request, standard terms for the supply of products".[228] Decisions would need to be made about which products obligations would apply to, and how retailers' ability to stock new products and discontinue products would be affected. It is difficult to see how significant effects on dynamism and innovation would be avoided and the existing diversity of offerings maintained, and

344.3 standard terms for supply (even if minimal) would need apply across all regulated product categories in a context where the commercial realities associated with supplying different products can vary. Any standard terms

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224 This is the average number of product cost price changes FSSI processes each year.

225 For example, under the Fuel Industry Act 2020, section 12 outlines that wholesale suppliers are only able to refuse supply on limited reasonable grounds and, in some scenarios, must ensure a prescribed minimum supply amount is supplied.

226 DIRA, sections 73-76 and 97.

227 Draft report at [9.49.2].

228 Draft report at [9.49.1].

prepared would need to be sufficiently generic so as to cover a wide range of products and very varied suppliers. A lack of specificity could limit the efficacy of any such terms. Further consideration is needed as to what any published standard terms could realistically include and what benefit they would provide.

***The lack of an existing wholesale market increases complexity***

345. There is a further critical difference between fuel and dairy on the one hand, and groceries on the other, which in FSSI's preliminary view significantly impacts the practicality of wholesale access. That is, in both fuel and dairy, there was a well-developed and distinguishable wholesale level of the market at the time that regulation was contemplated, and as such the Commission could focus on improving access to it. The existence of established wholesale markets had two particular flow on consequences:

345.1 it increased the confidence the Commission had that regulation of the wholesale market would flow through to increased competition at retail, and

345.2 the Commission was able to identify appropriate targeted regulation to improve wholesale competition based on the specific aspects of the wholesale market which were preventing effective functioning of the wholesale market.

346. In this case, the major grocery retailers do not participate in a wholesale market (other in FSSI's case than to convenience stores by Trents). This means the Commission is unable to come to similar conclusions or make similar recommendations in the grocery market:

346.1 as there is not a well-established wholesale grocery market, the Commission is unable to conclude, in the same way as it did for fuel and dairy, that an inactive wholesale market is causing its competition concerns at the retail level. As a result, the Commission's view that improving access to wholesale will lead to increased competition at retail is necessarily speculative,

346.2 the fact that there is not an existing wholesale market means the Commission does not have the ability to target its recommendations to specific issues within the wholesale market. This is reflected in the broad and non-specific recommendations made by the Commission and materially increases the work that would need to be done by regulation, and

346.3 as is developed elsewhere in this submission, FSSI does not currently deal with retail stores on anything like arm's length terms. This would add to complexity, particularly in relation to pricing. This issue would be of even greater significance in the context of operational or structural separation.

***Demand is uncertain***

347. As the Commission acknowledges, demand for access to wholesale supply is unknown.[229] This necessarily flows from the fact that there is no current wholesale market. It further reduces the certainty that the Commission can have that facilitating access to wholesale will lead to increased competition at retail.

348. A lack of certainty in demand also directly impacts FSSI, which would be obliged to supply at the wholesale level. FSSI has, obviously, designed and maintained a

229 Draft report at [6.153].

supply network to cater for expected levels of demand from its retail stores. At this preliminary stage, however, it is not clear whether FSSI's product and distribution network would have capacity to meet obligations under a wider wholesale access regime, whether this capacity would be sufficient to meet likely demand or whether any additional investment in capacity would be likely to be recovered.

349. Given the uncertainty in demand for wholesale, it would be extremely difficult for FSSI to make informed decisions about potential investment in its product and distribution network which, even if they could be overcome, would have ongoing cost implications. These sorts of issues did not arise, for example, in fuel, where aggregate demand was relatively predictable and a major part of fuel companies' existing business was supplying third parties at wholesale.

350. Further, in the case of any supply shortage, it will be important that FSSI is able to continue to service its retail stores and meet its own reasonable needs. Although regulation can in theory manage this issue,[230] it will be difficult to do so in a complex market lacking homogeneity. This is a particularly relevant consideration in the context of COVID-19. It is important that the supply chain remains robust and agile and able to respond to spikes in customer demand.

***Other considerations for terms of access***

351. Additional issues become apparent when considering the standard terms on which retailers would access products from existing suppliers. For example, should retailers:

351.1 receive volume-related discounts if they purchase a large quantity of products, and pay a higher price if they do not, reflecting, presumably, cost to supply? The answer to this question would have real impacts on the likely effectiveness of the regime, and

351.2 be charged prices that are differentiated according to their location, reflecting transport costs? This is particularly relevant in the context where FSSI operates a cross-subsidisation policy across its own retail stores, so that prices paid by stores are the same across the South Island. It would not necessarily be appropriate to implement non-discriminatory requirements which required suppliers to provide products to customers at equivalent prices to those provided to its own retail stores.

**Operational and structural separation**

352. Operational and structural separation would face difficulties over and above those identified with respect to the options involving existing wholesale grocery channels. This arises out of the fact that the co-operatives are not currently separable into a wholesale business and retail businesses, as there is no existing clear distinction between the two levels. Instead, each co-operative is a fully integrated, intricately linked, single business. As above, around the world, key grocery competition takes place on a vertically integrated basis, so there is also not an obvious model to copy. Effectively, the co-operatives' businesses would need to be fundamentally transformed, with associated cost and other implications, for the individual co-operative members who own the stores.

353. The Commission notes that, based on analysis by Frontier Economics, grocery prices do not vary significantly across the country. The Commission attributes this in part

[230] As it does with fuel. See section 12(e) of the Fuel Industry Act 2020.

to the fact that prices are set at the national level (in the case of Woolworths) or Island level (in the case of FSNI and FSSI). While that is true, FSSI operates a cross-subsidisation policy through the Co-operative. This ensures that FSSI retail stores pay the same price for groceries irrespective of the different costs to transport goods to the store. This benefits consumers in the regions, who could otherwise expect to pay higher grocery prices than those in urban areas, reflecting higher transport costs. It may not be possible for FSSI to maintain this cross-subsidisation under any wholesale access model, but that would be particularly the case under operational or structural separation. The outcomes for regional areas in particular would need to be carefully considered.

**Facilitation of new entrant at wholesale**

354. FSSI does not consider it appropriate to comment on whether the Government should consider becoming involved in grocery retailing. To the extent it has an appetite to do so, the discussion above should inform the competition and implementation considerations, particularly:

354.1 whether new entry at the wholesale level would be likely to resolve competition concerns that have been identified, and ultimately benefit consumers, as to which see above from paragraph 333, and

354.2 the associated costs, e.g. including start-up costs and prospective demand (discussed above at paragraph 347).

**IMPROVING ACCESS TO SUITABLE SITES**

**Introduction**

355. FSSI acknowledges the two factors that the Commission believes are impairing access to suitable sites for grocery retailing, namely:

355.1 difficulties in getting planning permission to develop potential sites, and

355.2 the use of restrictive covenants and exclusivity covenants in leases which prevent the use of potential sites.

356. FSSI addresses each in turn. As discussed in paragraph 287 of this response, FSSI believes the analysis should also extend to considering any other regulatory requirements that may limit a third player from acquiring land including the broad definition of sensitive land under the Overseas Investment Act 2005.

**Difficulties in obtaining planning permission**

357. FSSI supports the Commission's recommendations including the inclusion of a mechanism in the proposed Natural and Built Environments Act to ensure the potential benefits of competition are a relevant consideration.

**Use of restrictive covenants/exclusivity provisions**

358. As the Commission acknowledges, there is scope for debate and analysis as to the purpose or effect of any particular land covenant or exclusivity provision.

359. FSSI notes that it has never enforced a restrictive covenant that it has registered or had a restrictive covenant queried by a third party. Furthermore, FSSI has not had a situation where it has encountered a restrictive covenant that would impact its ability to operate a supermarket. This is an important point to note as the impacts and effects of restrictive covenants, while not easily quantified, may be being overstated with respect to the retail grocery industry.

360. Nonetheless FSSI is generally supportive of removing existing restrictive covenants on land, but agrees with the Commission's observation that identification and removal of these covenants from property titles would be an inherently difficult task. With regard to property it has sold, FSSI would be willing to provide a binding undertaking that any covenants on such property would not be enforced and that FSSI would not seek enforcement of such covenants. FSSI would also be willing to commit to not registering new restrictive covenants on land as part of the process of selling property.

361. Regarding restrictive covenants in leases, these are a complex matter that involve third party landlords. Often the reasoning for these covenants is to ensure a diversity of tenancies in a retail area, and provide a wide benefit. FSSI is open to the review of lease covenants, to ensure relevance and need.

362. Regarding restrictive covenants with land developers, these can be similar to lease covenants in that they are often to the benefit of the land developer. This is usually to enable a development to achieve critical milestone stages by securing anchor amenities. As with lease covenants, a review of restrictive covenants relating to developments should be carried out. FSSI is in principle agreeable to the notion that any covenants for a new development could be time restricted, and expire after a certain initial period.

363. FSSI's view is that a review is likely best undertaken as part of a separate programme rather than being addressed in the market study process.

**OPTIONS TO DIRECTLY IMPROVE RETAIL COMPETITION**

364. The Commission has noted the possibility of a Government sponsored new entrant in retail or divestiture of existing stores.[231] FSSI does not consider it appropriate for it seek to tell the Government whether it ought to become involved in grocery retailing, and instead simply notes that, in principle, many of the same arguments would apply to both methods of intervention.

365. FSSI considers that directly intervening in retail competition by requiring FSSI to divest some of its stores would be a drastic step to take. FSSI considers that, given the analysis presented in these submissions, these recommendations are 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 part of its retail business.

366. In addition, FSSI notes that Costco will imminently enter the retail grocery market. [ ].

367. In any event, FSSI agrees with the Commission's comments that the costs and risks associated with both of these measures are significant.[232] FSSI therefore agrees that these recommendations ought to only be considered after a cost/benefit analysis and as an option of last resort.[233]

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[231] Draft report at [9.100]-[9.106].

[232] Draft report at [9.102] and [9.106].

[233] Draft report at [9.102] and [9.106].

## OPTIONS TO IMPROVE COMPETITION FOR THE ACQUISITION OF GROCERY PRODUCTS

### Introduction

368. FSSI acknowledges the Commission's concerns regarding the bargaining position of major grocery retailers and the potential for grocery retailers to use that position in a way that ultimately results in consumer detriment and/or limits suppliers' ability or incentive to provide competitive supply terms to other retailers.

369. As discussed in its submission on acquisition of groceries by retailers above, FSSI believes that significantly more detailed analysis and evidence would be needed to justify any regulatory intervention in retailer/supplier interactions. However, as discussed below, as a matter of principle, FSSI is not opposed to a well-considered grocery code which deals with matters which are objectively unacceptable or outside commercial norms.

370. FSSI does not support the introduction of a collective bargaining regime on the basis that such a regime would lead to inefficiencies, increased transaction costs for and reduced competition among suppliers.

### FSSI supports a well-developed grocery code

371. FSSI supports a consumer focussed grocery code and is willing to participate in its development. FSSI's preliminary views are as follows:

371.1 the code should be mandatory for the reasons set out by the Commission and apply to all retail/wholesale participants in a way that ensures a level playing field,

371.2 the code should be developed in partnership with industry and Government (and could be part of a broader regime addressing codes of conduct if this was desirable),

371.3 dispute resolution, the extent to which non-compliance with the code should give rise to fines or penalties would need to be worked through in detail, and

371.4 similarly, the content of the code should be subject to further detailed analysis and consultation. While some of the content suggested by the Commission represents good ethical business practices, FSSI is concerned that other aspects of what has been suggested may fall into the category of regulation and should only be implemented following careful cost/benefit analysis including confirmation that the purpose of the rules are to be benefit consumers.

### Collective bargaining would be likely to have adverse consequences

372. The Commission suggests that collective bargaining, perhaps authorised on a class basis for smaller suppliers "may support some of the other options we have described" for strengthening competition. However, economic literature demonstrates a range of detriments arising from collective bargaining, including that:[234]

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[234] See, for example: King, S, *Collective bargaining in business: Economic and legal implications*, UNSW Law Journal, 36(1), 2013; and UK Office of Fair Trading, RBB Economics, *The competitive effects of buyer groups*, January 2007.

372.1 collective bargaining arrangements may become mechanisms for facilitating or encouraging cartel conduct, even though such conduct falls outside the scope of the authorised collective bargaining conduct (a 'spill over' effect),

372.2 collective bargaining increases the transaction costs arising from intra-group negotiations, as to succeed as a collective, a group of suppliers must first negotiate among itself so it can present a common position,

372.3 the requirement to restrain diverse interests and preferences within the bargaining group (in order for it to present a common position) leads to inefficiencies, and

372.4 more generally, collective bargaining leads to the loss of either and/or both price and non-price competition between members of the bargaining group.

373. These detriments are all likely to be magnified when the product about which the collective bargaining is taking place has the potential to be differentiated between one supplier and another (as is the case with most grocery products).

**OPTIONS FOR IMPROVING THE INFORMATION PROVIDED TO CONSUMERS**

**Introduction**

374. FSSI acknowledges the various findings the Commission has made regarding consumer issues. In particular, FSSI recognises that some consumers may be confused by complex promotional mechanisms, inconsistent use of unit pricing, and our Clubcard terms and conditions. FSSI is committed to improving our customers' shopping experience and to ensuring customers are able to make informed purchasing choices.

375. In light of the Commission's recommendations, FSSI agrees that:

375.1 the promotional mechanisms across its retail banners should be simplified. This finding focusses particularly on PAK'nSAVE and New World, given that Four Square uses relatively less promotional mechanics,

375.2 unit pricing should be standardised across all grocery retailers, and

375.3 improvements can be made to the Clubcard terms and conditions, to simplify and clarify our reward structure and ensure we provide appropriate information about our collection and use of data.

376. FSSI is giving full attention to each of these issues. However, given the time available, FSSI is still working towards producing more detailed proposal for how it will adapt its current practises to achieve the outcomes identified above. FSSI's preliminary views are recorded below.

**Simplification of promotional mechanisms**

377. FSSI strives to provide good value to its customers through promotions that offer genuine price savings. As the Commission acknowledges, FSSI's use of promotions has historically been driven by a strong consumer preference to buy products on promotion.[235] However, FSSI acknowledges that complex promotional mechanisms,

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[235] Draft report at [7.50]; Ipsos "Consumer behaviour and preferences in the New Zealand retail grocery sector – Consumer study report" (July 2021) at 9-10 and 43-44.

and their use in combination, can be confusing for customers, even where the underlying promotion is good value.[236]

378. As noted in FSSI's submissions on the issues paper, FSSI is already in the process of reducing the frequency of promotions and introduce more everyday low pricing strategy (EDLP). This applies a consistently low price to the products that matter most to customers, based on consumer insights (i.e. those products with consistent and high demand).[237]

379. FSSI also supports the Commission's recommendation that retailers should simplify and reduce the number of different promotional mechanisms and their use in combination.[238] FSSI uses varying numbers of promotional mechanics at each of its banners, with New World and PAK'nSAVE using relatively more than Four Square.

380. As part of this project, FSSI will give consideration to the Commission's recommendations that:

380.1 the tickets for different mechanisms are visually different and clearly indicate the type of mechanism being used, and

380.2 Clubcard deals are clearly labelled and are easily distinguishable from other tickets used in New World stores.

**Improving unit pricing**

381. FSSI agrees that consistent use of unit pricing helps consumers to make informed purchasing decisions, and it supports the Commission's recommendation that unit pricing should be used more widely and consistently.[239]

382. As the Commission has noted, New World, PAK'nSAVE and Four Square (SAP) stores currently provide unit pricing on all products except:[240]

382.1 products sold by weight or unit, which are by definition already priced by unit (e.g. produce, meat),

382.2 products where a unit price comparison is not applicable (e.g. gift cards), and

382.3 products where unit data provided by suppliers is incorrect.

383. FSSI acknowledges the Commission's findings that unit pricing could be used more widely in stores.[241] Additionally, FSSI intends to ensure that unit prices are provided for all products on promotion, including online.

384. FSSI would also be happy to work towards industry-wide standards for unit pricing, covering:

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[236] Draft report at [7.57].

[237] FSSI submissions on the issues paper, Q 46.

[238] Draft report at [9.147].

[239] Draft report at [9.153].

[240] Draft report at [7.105].

[241] Draft report at [7.109].

384.1 the range of products where unit pricing must be displayed,

384.2 what standard unit should be used for each type of product, and

384.3 how unit pricing should be displayed, including prominence and font size.

385. FSSI envisages that there will need to be exclusions for some products, including some general merchandise items which are not groceries (consistently with the Australian Unit Pricing Code)[242], services products, and café items.

**Clarifying Clubcard terms and conditions**

386. The New World Clubcard loyalty programme offers value to participating customers through member-only discounts ("Club Deals"), personalised discounts, as well as the ability to accumulate rewards that can be redeemed in store or with loyalty partners (i.e. Airpoints, Flybuys).

387. FSSI acknowledges the Commission's findings that some of the Clubcard terms and conditions are not clear to consumers. This particularly relates to how accumulated rewards and benefits work,[243] and how FSSI may collect and use consumer purchasing data.[244] While these matters are covered in the current Clubcard terms, FSSI agrees that more can be done to draw these matters to consumers' attention in a way that is clear and easy to understand.

388. FSSI intends to amend its Clubcard terms and conditions to ensure key terms and conditions are prominent and easy to understand.

389. FSSI will also consider whether it should use other means to draw key terms and conditions to consumers' attention, including by in-store displays or email.

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242 Australia Competition and Consumer (Industry Codes–Unit Pricing) Regulations 2021, cl 9.

243 Draft report at [7.130].

244 Draft report at [7.162].

Appendix A (Public version)

# Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability

**Report for Foodstuffs**

**September 2021**

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## Table of Contents

## Tables and figures

# 1. Executive Summary

## 1.1 Our brief

1. We have been engaged by the two Foodstuffs cooperatives[1] to comment on the Commerce Commission's analysis and findings with respect to profitability that were contained in its draft market studies report into New Zealand's grocery retailing sector.[2] In that report, the Commission reached the view that competition was not working effectively for the benefit of customers, and the Commission's conclusions in relation to profitability were a key evidentiary finding – and possibly the principal finding – that underpinned its conclusions.

## 1.2 The Commission's findings in relation to profitability

2. The Commission's primary measure of profitability was the return on average capital employed (ROACE),[3] and in assessing this the Commission:

   a. calculated the returns for the cooperatives at the level of the stores

   b. assumed the stores were "renters" of their land and buildings, and

   c. benchmarked returns principally against the Commission's estimate of the WACC, but also benchmarked the stores' returns against the Commission's estimate of the ROACE it estimated for a sample of international grocery retailers.

3. The Commission estimated the returns of the cooperatives' stores to have been in the range of 20-25 per cent, which were well in excess of the Commission's estimate of the WACC for grocery retailing (for which it estimated a range of between 4.6 per cent and 6.1 per cent), the returns the Commission estimated for the sample of international grocery retailers (average over the 2015-19 period of 11.3 per cent) and was also well in excess of the five-year average ROACE for the firms in the NZX 50 (excluding banks).[4]

4. The Commission also considered the IRRs for new investments that were contained in the cooperatives' business plans, and three forms of profit margin (gross profit as a percentage of revenue, earnings before interest and tax as a percentage of revenue and net profit after tax as a percentage of revenue. The Commission concluded that these other measures of profitability either corroborated, or did not contradict, its findings that the Foodstuffs cooperatives were earning excessive returns.

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1 Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI). We would like to acknowledge the helpful comments received from Greg Houston of HoustonKemp Economists in the preparation of this report.

2 Commerce Commission New Zealand (29 July, 2021), *Market study into the retail grocery sector, Draft report.*

3 Commerce Commission New Zealand (29 July, 2021), *Market study into the retail grocery sector, Draft report*, para.C.220.

4 New Zealand Commerce Commission (29 July, 2021), *Market study into the retail grocery sector, Draft report*, paras.3.36-3.37.

## 1.3 Our comments

### 1.3.1 Methodological issues

***Renter vs. owner***

5. First and foremost, we believe the Commission has made a material error by not accounting for the financial leverage that is implicit when a supermarket chooses to rent its key assets (i.e., land and buildings) rather than to own them. The Commission's assumption that the Foodstuffs' stores wholly rent their land and building assets means that the ROACE the Commission has calculated is a very highly leveraged return, which has been benchmarked against returns that are (largely) unlevered.

   a. In our view, it would be more economically meaningful to benchmark returns on the assumption that firms own (rather than rent) their assets, which we note is the intention of the new accounting standard for leases (IFRS 16). In addition, the cooperatives do own the vast majority of the land and buildings that are employed to undertake grocery retailing, and so this assumption would accord with reality and avoid the need to apply potentially erroneous hypothetical assumptions.

   b. If, however, a "renter" benchmark is to be assumed then this needs to be compared against the (much higher) benchmark return that would be consistent with this higher level of leverage.

***Returns should be estimated for the whole of the cooperatives' businesses***

6. In our view, a more appropriate assessment of Foodstuffs' profitability would be obtained from the returns across the whole of each of the cooperatives, rather than focussed on the store level only. We say this for three reasons.

   a. First, as the cooperatives' centres undertake a substantial part of the retail grocery activities, the stores cannot be considered an economically distinct activity, and so estimating a return at the store level is artificial.

   b. Secondly, as the store owners are the ultimate owners of the cooperative, the intra-cooperative payments cannot be assumed to be fully cost-reflective, and so arm's length charges would need to be imputed. This introduces error to the analysis of store-level returns.

   c. Thirdly, analysing the cooperatives on a whole of business basis would provide a more valid comparison with the sample of international grocery retailers, and would also be consistent with the Commission's treatment of Woolworths NZ.

***Other issues with measuring ROACE***

7. We agree with the Commission's view that the correct valuation method for assets is the current day market value or replacement cost, at least to the extent that it is practicable. In principle, the asset value should also include the valuable economic assets that firms create in relation to operational capability, human capital and the like, which are not recognised as assets for accounting purposes, although deriving a precise value for these

intangible assets is difficult. In our view, however, the likely presence of these assets provides a strong basis for benchmarking a grocery retailer's returns against the returns estimated for other grocery retailers, as both returns in this case would be equally affected by the omission of unbooked intangible assets.[5]

8. In relation to the expected revaluation gain from land and buildings, we recommend applying a long-term CPI forecast as a base case, albeit with sensitivities tested around this given the difficulty of deriving a soundly-based forecast of revaluation gains.

### *Returns should be benchmarked against those of international grocery retailers*

9. Benchmarking the cooperatives' returns against international grocery retailers provides a substantially more robust test of whether returns are reasonable. Moreover, we consider that the preferable point of comparison for the ROACEs the Commission estimates is provided by the returns observed for the set of international grocery retailers. We say this because:

   a. Compared to benchmarking against the WACC, applying this comparable return avoids the uncertainty associated with deciding which WACC should be expected to be impounded into competitive market prices, and also allows for the fact that the true "capital employed" by grocery retailers is likely to comprise valuable assets that are not included as assets in accounting statements. The likely presence of these unbooked intangible assets means that false positives are likely if a simple comparison is made against an estimate of WACC.

   b. There is no economic merit in the Commission's benchmarking of returns against the NZX50. The return the Commission has estimated is dominated by firms that are low risk, infrastructure firms and, indeed, many of which are price regulated. If attention were restricted only to firms whose activities are similar to those of the cooperatives, then a return that is more commensurate with the return measured for the cooperatives would be found.

### *Other measures of profitability*

10. <u>In relation to the IRRs cited in business plans</u>, we think that little information can be derived from an examination of the expected IRR in these plans as these values ordinarily take account of incremental values only, and so ignore the sunk/fixed costs that are employed. Moreover, in relation to the hurdle rates applied, the Commission should give weight to the process under which the hurdle rate was derived rather than simply comparing to the Commission's estimate of the WACC, given that independent experts may reach materially different views about the WACC for a particular activity.

11. <u>In relation to the various profit margin indicators</u>, we think the measures that should be considered are the gross profit margin and the "earnings before interest, taxation,

5 In contrast, a critical assumption when benchmarking a return on capital employed against the WACC is that the capital employed includes all of the economic assets that a new entrant would need to reproduce or acquire for it to operate on an equal basis.

depreciation and rent" (EBITDAR) margin as both are independent of the "rent vs. own" decision and firms' (traditional) debt financing decisions.

***Substantial departure needed to decide that competition is ineffective***

12. A consequence of the comments above is that the evidence would no longer be clear-cut that the Foodstuffs cooperatives are making returns that exceed a competitive market benchmark. Indeed, on some metrics the returns of the cooperatives are below the relevant benchmark. Thus, a consideration is required as to how much of a departure from normal the indicators of profitability need to be before it can be taken as evidence that competition is ineffective.

13. In our view, there is substantial support for the proposition that the inherent weaknesses in testing a firm's profitability imply that a departure from "normal" that is both large (with other competition authorities applying terms like "unequivocally substantial" and "significant"), persistent and not explained by superior efficiency before it can be taken as evidence that competition is ineffective.

### 1.3.2 Our findings on profitability for the Foodstuffs cooperatives

14. We have applied the Commission's sample of international grocery retailers[6] to what we believe are the appropriate indicators of "normal" for ROACE and the two profit margins that we consider to be appropriate. Our calculations include the following adjustments to the Commission's calculations:

   a. an adjustment for the effect of renting on the observed ROACE, as discussed in paragraph 2 above,[7] and

   b. removal of excess cash holdings for the firms that are outside of western Europe, North America and Australia.

15. Our profitability benchmarks, and the returns for the cooperatives (on a whole of business basis) calculated on a comparable basis, are set out in Table 1.

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6 We have removed one company from the sample, which is a holding company of another company that was already in the sample (and so is a double-up). We have also removed a small number of firms in relation to certain indicators where they were inappropriate (for example, firms with negative capital employed).

7 This adjustment is very similar in form to the adjustment that is made to de-lever a return on equity into a return on capital.

**Table 1 – Summary of profitability measures and the performance of Foodstuffs**

| | 2000-19 | 2010-19 | 2015-19 |
|---|---|---|---|
| Return on average capital employed | | | |
| First quartile - averaged | 6.2% | 5.8% | 5.2% |
| Average - averaged | 10.5% | 10.2% | 9.2% |
| Third quartile - averaged | 13.2% | 13.4% | 12.6% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **9.2%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **11.5%** | |
| Gross profit margin | | | |
| First quartile - averaged | 22.2% | 22.1% | 22.5% |
| Average - averaged | 23.7% | 24.3% | 24.9% |
| Third quartile - averaged | 26.6% | 27.0% | 27.4% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **22.2%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **22.4%** | |
| Earnings before interest, depreciation, amortisation and rent | | | |
| First quartile - averaged | 6.6% | 6.5% | 5.9% |
| Average - averaged | 7.5% | 7.6% | 7.1% |
| Third quartile - averaged | 8.8% | 9.0% | 8.8% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **8.1%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **7.1%** | |

16. A comparison of the performance of Foodstuffs against the range of outcomes observed for the international grocery retailers shows that:

   a. on a number of profitability measures, the outcomes for the cooperatives are very close to the average of the international grocery retailers (FSNI ROACE and FSSI EBITDAR)

   b. on one measure (gross profit margin), a lower level of profitability is indicated for the cooperatives than for the international grocery retailers, and

   c. in all cases, the cooperative's profitability indicators are within the range of experience with that of the majority of the international grocery retailers, namely sitting within the interquartile range.

17. Thus, we conclude that our assessment of the profitability of the Foodstuffs cooperatives does not support an inference that competition is not working effectively for the benefit of consumers.

# 2. Measuring profitability – conceptual issues

## 2.1 The Commission's approach to assessing profitability

18. The Commission's primary measure of profitability for its analysis of whether or not the outcomes observed in the retail grocery sector were consistent with competition working effectively was the return on capital employed.[8] In relation to this measure, the Commission:[9]

a. Calculated the Return on Average Capital Employed (ROACE) for Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI) at the level of the stores, drawing on store-level financial accounts.[10]

b. Assumed in this analysis that the stores are renters of their land and buildings assets (these assets are principally owned by the cooperatives – and therefore ultimately the store owners – although a rent is paid from the stores to the cooperative centres for the use of these assets).

c. Compared those ROACE's to an international sample of grocery retailers and an estimate of the WACC for the grocery retailing activity (with the asset beta and assumed gearing level also calculated with reference to the same international sample of grocery retailers), and

d. Calculated ROACE:

i. with cash left in the denominator (i.e., as part of the capital employed)

ii. with goodwill excluded

iii. on the basis of the book value of assets (most relevant for the returns calculated for the centres), albeit with a sensitivity applied to factor in an estimated market value

iv. with a sensitivity applied to remove the effect of financing flows within the cooperatives and stores, and also to attempt to factor in a proper (i.e., fully costed) allowance for the services provided to the stores by the cooperative centres.

19. The Commission calculated returns on capital employed in the range of 20-25 per cent, which were well in excess of the Commission's estimate of the WACC for grocery retailing (for which it estimated a range of between 4.6 per cent and 6.1 per cent), the

8 Commerce Commission New Zealand (29 July, 2021), *Market study into the retail grocery sector, Draft report*, para.C.220.

9 These are the assumptions that flowed into the results reported in: Commerce Commission New Zealand (29 July, 2021), *Market study into the retail grocery sector, Draft report*, Figures 3.2 and C.9.

10 The Commission conducted sensitivities that also had regard to the profitability of the cooperative centres (Commerce Commission New Zealand (29 July, 2021), *Market study into the retail grocery sector, Draft report*, paras.3.44-3.50).

returns the Commission estimated for the sample of international grocery retailers (and average over the 2015-19 period of 11.3 per cent) also well in excess of the five-year average ROACE for the firms in the NZX 50 (excluding banks).[11]

20. The Commission also assessed the cooperatives against the following other measures of profitability, namely:

a. In relation to business plans for new investment:

i. The internal rates of return that was expected from the relevant investments, which it concluded were above its WACC estimate, and

ii. The hurdle rates that were applied in the business plans, which it also concluded were also above its WACC estimate, and

b. Three forms of profit margin, namely:

i. the “gross profit margin” (the margin from sales above the cost of goods sold) as a proportion of revenue – where it found that the margins for the two cooperatives were lower than in the sample of comparable entities, although it discounted this fact on the basis that the cost of goods sold for the cooperatives may be biased upwards due to the inclusion of funding for centre activities[12]

ii. “earnings before interest and tax” as a proportion of revenue, which was benchmarked against the same measure for the sample of overseas firms – which it concluded was materially higher for the two cooperatives than for the comparable entities,[13] and

iii. “net profit after tax” as a proportion of revenue, which was also benchmarked against the same measure for the sample of overseas firms – which the Commission concluded was also materially higher for the two cooperatives than for the overseas sample, although the Commission in this case commented that the NPAT margin may be biased upwards as a consequence of the store rents being below commercial rates and the fact that the stores’ costs of goods sold does not include the full cost of the services provided by the cooperatives.[14]

21. Thus, the Commission concluded that these other measures of profitability either corroborated, or did not contradict, its findings that Foodstuffs was earning excessive returns.

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11 New Zealand Commerce Commission (29 July, 2021), *Market study into the retail grocery sector, Draft report*, paras.3.36-3.37.

12 New Zealand Commerce Commission (29 July, 2021), *Market study into the retail grocery sector, Draft report*, para.226.

13 New Zealand Commerce Commission (29 July, 2021), *Market study into the retail grocery sector, Draft report*, para.229.

14 New Zealand Commerce Commission (29 July, 2021), *Market study into the retail grocery sector, Draft report*, para.230.

## 2.2 Issues with the Commission's method

### 2.2.1 Overview

22. An overview of our comments in relation to the Commission's assessment of profitability is as follows.

a. First and foremost, we believe the Commission has made a material error by assuming that the Foodstuffs stores rent all of their land and buildings assets – and so has assumed a very high level of leverage – but has compared this against benchmark returns that are (largely) unlevered. The appropriate course of action would to be to assume that stores their and buildings assets, which is the case in reality. Failing this, the returns of a renter needs to be benchmarked against the estimated returns against the (much higher) benchmark return that would be consistent with a firm that rents most of its assets.

b. Secondly, in our view, a more appropriate assessment of Foodstuffs' profitability would be obtained from the returns across the whole of each of the cooperatives, rather than focussed on the store level only.

c. Thirdly, in relation to the technical measurement and benchmarking of ROACE:

   i. we agree with the Commission's stated preference for applying the current market value of assets when estimating ROACE

   ii. consider that in relation to cash, care is required to ensure that return benchmarks are not affected by firms' excessive cash balances – we suggest using a "normalised" level of cash or removing cash from capital employed.

d. Fourthly, we consider that the preferable point of comparison for the ROACEs the Commission estimates is provided by the returns observed for the set of international grocery retailers. In our view, this would provide a far more robust point of comparison than benchmarking against either the WACC or the ROACE earned on the NZX50.[15]

e. Fifthly, in relation to other measures of profitability:

   i. <u>In relation to business plans</u>, we think that little information can be derived from an examination of the expected IRR in these plans. In relation to the hurdle rates applied, the Commission should give weight to the process under which the hurdle rate was derived rather than simply comparing to the Commission's estimate of the WACC.

   ii. <u>In relation to the various profit margin indicators</u>, we think the measures that should be considered are the gross profit margin and the "earnings before interest, taxation, depreciation and rent" (EBITDAR) margin as both are

15 Having said that, we comment that the observed ROACE for the most relevant firms in the NZX50 is not materially different to the experience of the Foodstuffs cooperatives.

independent of the "rent vs. own" decision and firms' (traditional) debt financing decisions.

23. We address these matters in turn.

24. A consequence of the changes I recommend to how profitability is assessed is that it is no longer clear-cut that the Foodstuffs cooperatives are making returns that exceed a competitive market benchmark, indeed on some metrics the returns of the cooperatives are below the relevant benchmark. Given this, it is essential also to consider the strength of the evidence in relation to profitability that is required before that evidence can be interpreted as supporting a finding that competition is not working effectively, in view of the real-workings of markets. I therefore also provide some observations on this matter below.

### 2.2.2 Renting vs. ownership of assets and hidden leverage

#### *Effect of renting on required returns*

25. Whether a firm is assumed to be a renter or an owner of the assets that it employs will have a material effect on the return on capital that is measured for the firm (i.e., under the pre-IFRS 16 accounting standards) and that the firm requires. This reflects the fact that the decision of whether to rent an asset or to own an asset is a financing decision, and an alternative way to standard debt financing to participate in an activity with less equity finance. Thus, a firm that wanted to commence in a retail grocery operation without contributing material equity finance could:

a. rent its land and buildings under a long-term lease, or

b. purchase and own its land and buildings, and wholly debt finance this purchase.

26. Both of these are essentially identical – both imply that part of the firm's cash flow first needs to be devoted to a material fixed commitment (i.e., the rent or interest payments), and so in both cases the variance of the residual cash-flow increases and, with it, the required return.[16] However, in the Commission's calculations, only the effect of traditional debt finance on required returns has been recognised – the effect on leverage of leased assets has been ignored. I note that the leases have been recognised as a source of financial leverage in the economic finance literature, as well in practice in investment banking for sectors where a high rate of leasing of assets is common.[17]

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16 The proposition that the required (equity) return will increase with financial leverage has been accepted by the Commerce Commission (and all Australian regulators) in all decisions made over the last two decades.

17 For example, in the airline industry: "The measure of market debt to capital ratio (that is, debt plus equity) includes the effect of operating lease payments capitalised as a debt equivalent…" See Bureau of Transport and Communications Economics, (1993), *International Aviation*, Report 86, Canberra, p.213. As a second example, the key financial information for Woolworths Ltd in the Grant Samuel Independent Expert Report for the demerger of Endeavour Group reported the gearing level with lease assets and liabilities both excluded (8.4 per cent) and included (64.5 per cent) in the calculation: Grant

27. The new accounting standard for leases, IFRS 16, requires a recognition of both the interest cost (Operating lease Interest Expense) and the asset (Right of Use Asset) and liability (Capitalised Operating Lease Liability) implications of renting.[18] The main effects are:

    a. *Income Statement* – former rental payments are now separately identified (divided into) operating lease interest and operating lease depreciation components, and

    b. *Balance Sheet* – formerly the sum of future operating lease payment obligations were provided in notes to the accounts, but now are capitalised into a Right-of-Use asset offset by an Operating Lease Liability.

28. In this way the new accounting standard will align more closely with the underlying economic relationships,[19] and so place renters and owners on a more level playing field.[20] As a result, future comparisons of the ROACEs of renter and owners businesses using headline results will have greater validity than those undertaken for pre-IFRS 16 reporting firms as the Commission has sought to do.[21] However, an adjustment to pre-IFRS 16 ROACEs can be readily achieved to make them comparable at any level of ownership by using an adaptation of the Modigliani-Miller leverage equation, which is described in Appendix A.

29. In summary, IFRS 16 assists in benchmarking as it is intended to align financial accounts with the ownership model. This standard substantially improves the economic meaning of financial accounts, which is a proposition the Commission has endorsed for regulated

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Samuel, 2021, Concise Independent Expert's Report in relation to the Proposed Demerger of Endeavour Group Limited by Woolworths Group Limited, May, (Annexure A of Woolworths Ltd Demerger Booklet for the Demerger of Endeavour Group, 10 May 2021), p.9.

18 See https://www.iasplus.com/en-gb/news/2016/01/ifrs-16, "IASB issues new leasing standard" (iasplus.com) for a high-level summary of the IFRS 16 standard.

19 We note that IFRS 16 will not perfectly replicate the position of an asset owner, given that the value of the right-to-use asset and lease liability reflect the present value of outstanding lease payments, and further that these values are required to reflect only the extent of the future lease payments that are certain (adjustments then to be made over time for the effects of variable rent indexation [such as CPI] or price reviews once they occur). Thus, the asset value (and associated liability) will tend to be understated as they will not incorporate the residual value element after the expiry of the lease, or the effect of variable rent escalation. However, returns calculated under IFRS 16 will be much more consistent with the position of an owner than under the previous accounting standards, and will be reasonably close to that of an owner where lease terms are very long (which is the norm in relation to supermarket sites).

20 In the US a new accounting standard, ASC 842, has been introduced in parallel with IFRS 16 that applies some of the lease accounting features of the latter. In particular, the Right of Use Asset is added to the Total Assets, but the interest cost is not recognised. Hence, while NPAT does not change, EBIT and EBITDA increase under IFRS 16 (for international firms) but not under ASC 842 (for US reporting firms).

21 We note that for the Commission's sample businesses, Total Assets, which for those international firms applying either IRFS 16 or US firms applying ASC 842 during 2018 and 2019 will have the effect of increasing the denominator and reducing the ROACE value calculated in these years relative to previous years (2015-2017) other things being equal.

businesses. For example, when considering whether to follow the IFRS 16 standard in relation to the electricity lines businesses, the Commission observed as follows:[22]

*Subject to the specific exceptions discussed, we consider the rationale for allowing suppliers to include finance leases in their RAB, as provided for under the existing IMs, is equally applicable to the capitalisation of operating leases, as now provided for by GAAP. Our rationale for including finance leases in the RAB is that it is efficient for electricity lines businesses to choose leases over the option of owning the asset, where it minimises the cost over the asset life. Compared to operating leases, finance leases typically apply to lower value and shorter-lived assets and, therefore, we consider there are even greater efficiency implications for operating leases in the decision of whether to enter right of use leases or to purchase assets.*

30. Universal reporting under the new IFRS 16 accounting standard across the international grocery retailers discussed in Chapter 3 only commenced from financial year 2020, although a number of the international grocery retailers reported under the new standard in 2018 or 2019.

### *A simple, stylised example*

31. Table 2 provides a stylised example that shows the position under an ownership model, and also illustrates the leveraging effect of renting on a number of financial indicators that were discussed above. In all cases, the revenue and expenses of the firm are identical and in all cases the firm provides the equity finance for the inventory and fittings assets. In relation to the land and building assets, the firm is assumed to choose between:

a. purchasing (and owning) the assets and securing normal debt finance to fund the purchase, or

b. entering into a long-term lease for the assets.

32. The results presented in the three columns are as follows:

a. the first column shows the outcome if the firm purchases and debt-finances the land and buildings assets

b. the second column shows the outcome if the firm enters into a long-term lease for the land and buildings under the accounting standards that pre-date IFRS 16, and

c. the third column shows the outcome if the firm enters into a long-term lease for the land and buildings and reports under IFRS 16.

33. Comparing the first and second column (i.e., pre-IFRS 16), it is seen that if a firm leases the land and buildings assets, then:

22 Commerce Commission (2019), Treatment of operating leases – final decision paper, November, para.4.6.2. The Commission identified a number of practical issues arising from the change in treatment of these costs in light of the existing Input Methodologies, which was the main topic of this consultation.

a. EBITDA and EBIT will be much lower than the case where the firm owns the assets as the full rent cost is treated as operating expenditure even though a large share of this expense is, in reality, a financing charge

b. total assets (capital employed) will be much lower than the owner as there is no recognition of the value associated with the land and buildings assets

c. its EBITDA and EBIT margins will be much lower than the case where the firm owns the assets, although its EBITDAR margin[23] will be the same in both cases as this measure of profit is prior to rent,[24] and

d. its return on assets (capital employed) will be materially higher than the case where the firm owns the assets, and indeed is equal to the post-financing return (i.e., return on equity) for the owner.

34. It can be observed from the third column the application of IFRS 16 effectively restores the position of a renter to that of an owner, and in doing so create a more comprehensive accounting of economic assets employed and sources of financing. Specifically:

a. total assets (capital employed) will include the land and buildings, and

b. the various measures of profit (i.e., margins and returns) align with those of the case of ownership.

35. It is clear from the example above that the fact that a renter will make a return on assets of 17.3 per cent, whereas an owner will make a return on capital employed of only 5.4 per cent, means that the 17.3 per cent is in fact a leveraged return, and so not a true pre-financing return.

a. That is, under the renter model, the return on capital employed of 17.3 per cent is only derived because an important source of financial leverage (renting) is ignored from the calculation.

b. Similarly, the presence of a return on capital employed of 17.3 per cent for a renter is not an indication that excess returns are being made – compared to the owner, the higher return on capital employed is required because, as the return is a much more highly leveraged, it brings with it a much higher risk.[25]

c. Clearly, therefore, if the return on capital employed earned by a renter were to be benchmarked against the return on capital employed of an owner, then a real likelihood exists for the renter to be incorrectly diagnosed as making excess returns.

36. Relevant to the current matter, the Commission's calculation of ROACE for the Foodstuffs stores has assumed that land and buildings are wholly leased, which is

23 Earnings before interest, tax, depreciation, amortisation and rent.

24 The gross profit margin will also be the same in all cases as this measure counts as costs only the cost of goods element, and so is prior to any occupancy-based costs (i.e., rent, interest and/or depreciation).

25 That is, as with debt finance, the requirement to make fixed rent payments implies that the variability and co-variability of the residual cash flow will increase, which raises the cost of capital.

equivalent to assuming that only approximately 30 per cent of economic assets employed were owned. However, those ROACE estimates were benchmarked against firms that, on average, owned approximately two-thirds of their assets. As noted earlier, this was an error.

**Table 2 – Return on capital for an owner vs renter (pre-IFRS 16)**

| | Owner | Renter (pre-IFRS 16 financial accounting) | Renter (economic effect / IFRS 16) |
|---|---|---|---|
| [1] **Profit and loss** | | | |
| [2] Sales | 1,000 | 1,000 | 1,000 |
| [3] Cost of goods sold | 850 | 850 | 850 |
| [4] **Gross Profit** | **150** | **150** | **150** |
| [5] Opex (excl rent/depn) | 50 | 50 | 50 |
| [6] Rent | | 50 | |
| [7] **EBITDA** | **100** | **50** | **100** |
| [8] Depreciation | 22 | 2 | 22 |
| [9] **EBIT** | **78** | **48** | **78** |
| [10] Interest | 30 | | 30 |
| [11] Tax | 13 | 13 | 13 |
| [12] **NPAT** | **35** | **35** | **35** |
| [13] **Balance sheet** | | | |
| [14] **Assets** | | | |
| [15] Inventory and Fittings | 200 | 200 | 200 |
| [16] ROU Asset | | | 1,000 |
| [17] Land & Buildings | 1,000 | | |
| [18] **Total Assets** | **1,200** | **200** | **1,200** |
| [19] **Liabilities** | | | |
| [20] Debt | 1,000 | | |
| [21] ROU liability | | | 1,000 |
| [22] **Total Debt** | **1,000** | **-** | **1,000** |
| [23] **Total Net Assets** | **200** | **200** | **200** |
| [24] **Key financial indicators** | | | |
| [25] **Gross profit margin (%)** | 15.00% | 15.00% | 15.00% |
| [26] **EBITDAR margin (%)** | 10.00% | 10.00% | 10.00% |
| [27] **EBITDA margin (%)** | **10.00%** | **5.00%** | **10.00%** |
| [28] **EBIT margin (%)** | **7.80%** | **4.80%** | **7.80%** |
| [29] **NPAT margin (%)** | 3.46% | 3.46% | 3.46% |
| [30] **Return on capital employed (%)** | **5.38%** | **17.28%** | **5.38%** |
| [31] **Return on net assets (equity) (%)** | 17.28% | 17.28% | 17.28% |

*Source: Incenta*

***Choice of ownership vs. renting and the benchmarking of returns***

37. The implications of the discussion above are that:

a. when assessing the appropriateness or returns, a choice is required as to whether returns are derived under the assumptions of "asset ownership" or "asset renting", and

b. the benchmark against which returns are measured needs to be consistent with the choice about the extent of ownership vs. leasing – that is, to factor in the level of hidden leverage that is assumed.

38. A key implication of this discussion about benchmarking is that it is invalid to simply compare returns for one firm to the returns from a sample of international firms, or to an estimated WACC, at least prior to IFRS 16. To this end, we note that the Commission's calculation of ROACE for the Foodstuffs stores assumes a level of renting of approximately 70 per cent, and hence a substantial level of financial leverage. However, the benchmarks against which this has been compared assumed a substantially lower level of leverage (this issue is discussed further in section 3.1.4), and so in our view was a material error in the Commission's analysis.

39. In relation to whether the assumption of an owner or renter should be applied when assessing the returns of the Foodstuffs cooperatives, our strong view is an ownership assumption should be applied. We say this for three reasons.

a. First, in the next section we conclude that ROACE for the Foodstuffs entities should be calculated on a whole of business basis, that is, the consolidated return across the stores and cooperatives' centres. In practice, the cooperatives own the vast majority of the land and building assets that they employ to undertake grocery retailing, and so applying an ownership benchmark is consistent with its actual situation, and so should be preferred.

i. If the assumption of a renter rather than owner were to be applied, then this requires the imputing of hypothetical rents for the land and buildings.

ii. Whilst the use of benchmark (hypothetical) assumptions may be applied in economic regulation, this is done where there is a compelling economic justification, such as where applying the actual circumstances of a business may generate perverse incentives or result in prices that embody inefficiency. This is because applying hypothetical assumptions in a calculation brings with it the potential for error.

iii. For the further reasons below, we do not think that such a compelling economic justification for adopting the hypothetical assumption that the cooperatives rent assets (rather than own) exists in this case. In fact, we think economic principles favour an assumption of ownership as the appropriate benchmark.[26]

b. Secondly, from an economic perspective, adopting the ownership perspective ensures that the assessment of returns is based on the broadest possible scope of economic assets that are employed to undertake grocery retailing are included in the calculated "capital employed", and so will result in a better measure of the economic returns from the activity.

26 For the avoidance of doubt, our view is even if the Commission was to calculate returns at the level of the cooperatives' stores it should measure returns on the assumption that the stores own the assets that they employ. The simplest means of achieving this is to allocate the assets (and associated depreciation and expenses) that are owned by the cooperative centres to the stores when calculating returns.

c. Thirdly, also from an economic perspective, adopting the assumption of asset ownership (over renting) is also consistent with ensuring that the measurement of returns is independent to the maximum extent of how firms choose to finance their activities, which is a desirable objective and consistent with the Commission's long-standing practice of ignoring financing decisions when assessing or calculating returns.

40. However, if the Commission is to pursue a renter assumption, then the benchmark that profit is compared against needs to be raised to be consistent with the level of hidden leverage in the store level returns.

41. It also follows from the discussion above that the benchmarks for ROACE that are derived from comparable entities need to be either consistent with, or adjusted to be consistent with, the level of ownership that is assumed when calculating ROACE for the firm being assessed (i.e., where returns from pre-IFRS 16 accounting statements are observed). To the extent the target firm rents a higher proportion of the assets employed than the comparable firms, then the return it is being benchmarked against will be too low, and vice versa if the firm being assessed has a lower level of renting.

42. In practice we observe a range of ownership levels in the Commission's sample, albeit with an average level of ownership that is more than twice what the Commission implicitly has assumed for the Foodstuffs stores, although with a level of renting observed. It follows from this that an adjustment to the "headline" returns would be required in all cases and result in:

a. a (much) higher benchmark return if the renter assumption is applied, and

b. a lower benchmark return if the owner assumption is applied.

43. In Appendix A we show that the return on capital of a firm that rents a proportion of its assets will be related to the return on capital for a firm that owns all of its assets according to the following formula:[27]

$$R = r + \left(\frac{1-\gamma}{\gamma}\right)(r-\alpha)$$

and

$$r = R.\gamma + (1-\gamma).\alpha$$

Where:

$\gamma$ = proportion of the total assets employed that are owned, with $(1 - \gamma)$ being the proportion that are rented

27 Whilst we set out the derivation of this formula in Appendix A, we note that it is essentially an adaptation of the formula for the effect of leverage derived by Modigliani and Miller: see Modigliani, F. and M.H. Miller, (June, 1958), "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, pp.261-297.

$\alpha$ = implicit rental interest rate after tax (i.e., [1-28%] x "headline" implicit interest rate)

$r$ =return (ROACE) for a 100 per cent owner of assets

$R$ = return (ROACE) for a firm that rents $\Upsilon$ proportion of the total assets employed.

44. In Chapter 3 we apply this formula to adjust the returns in the Commission's sample of comparable entities to be consistent with the returns that would have been received by an owner of assets, as well as a firm that rents assets in the approximate proportion that was assumed in the Commission's calculations.

### 2.2.3 Whole of business returns should be preferred

45. As discussed above, the Commission's principal focus for the Foodstuffs cooperatives was on the returns that were made at the level of the stores, rather than for the cooperatives as a whole. In our view, the return that is calculated would be substantially more meaningful and reliable if calculated for the whole of each of the cooperatives, for three reasons.

a. First, we understand from Foodstuff's submissions that the cooperative centres undertake key functions in relation to the grocery retailing operations, which include making decisions over the opening and closing of stores, the selection of store owners, pricing decisions (with some contribution also at the store level) and product selection (with some contribution also at the store level), running of promotions and IT provision, such that the stores, under the cooperative structure, would not be a self-sustaining activity. This suggests that the stores are not functionally separate activities and so it is not economically meaningful to treat them as separate activities.

b. Secondly, if the stores were to be treated as separate activities, then it would be necessary to ensure that the revenues, expenses and assets ascribed to the stores capture the full economic cost of all of the activities the cooperatives centres undertake for the stores. Importantly, there is no reason to assume that the charging structure currently in place between the cooperative centres and stores would capture the full economic costs of the centres' activities given that the stores are the ultimate owners of the cooperatives. However, imputing full (economic) cost intra-firm charges itself is sensitive to the assumptions applied, such as the scope of assets considered and the profit margin assumed to be required for the centres' activities, and this potential for error is avoided by assessing the returns on a whole of business basis.

c. Thirdly, our review of the sample of comparable international returns the Commission has considered (which in turn has flowed into the Commission's estimate of the WACC and benchmark return) suggests the sample is dominated by firms that undertake similar functions as the whole of the cooperatives (noting again that the cooperative centres undertake many essential functions on behalf of the stores). Thus, assessing the returns of the cooperatives as a whole would be more consistent with the benchmarks that are being applied. Consistent with this, it is noted that the

Commission has calculated a return for the whole of Woolworths NZ, whose activities are comparable to the whole of the cooperatives.

46. If returns were to be benchmarked at the store level, however, it would be essential for appropriate charges to be imputed for the activities of the centres. That said, we do not think that returns calculated on this basis are economically meaningful for the reasons set out above.

### 2.2.4 Other issues with measuring ROACE – treatment of cash and asset valuations

#### *Treatment of cash*

47. The Commission's calculations of ROACE for both the Foodstuffs stores and the sample of international grocery retailers are based on a definition of capital employed that includes the whole of cash balances. In our view, this has introduced an error in the benchmarking of Foodstuffs' returns.

48. Cash may be held by firms for a variety of reasons, some of which may be related to the conduct of a particular activity, whereas others may not – for example, the desire to have a "war chest" available to fund future acquisitions. Accordingly, it is important for cash balances to be normalised so that cash held for other purposes is excluded from the measurement definition.

49. One technique for normalising for the amount of cash would be simply to exclude cash from the definition of capital employed, and to apply this consistently to both Foodstuffs and the sample of comparable entities. This would result in the ROACE for the Foodstuffs entities increasing, but also raise the ROACE for the sample of comparable entities, and so place the firms on a level playing field. It would not be appropriate to calculate the ROACE for the Foodstuffs entities if a comparison is to be made to the WACC, however.

50. A second technique would be to replace the cash balances for firms with a normalised amount, with the normalised amount calculated with reference to the practice of firms in a comparable situation to the Foodstuffs entities.

51. We analyse the cash balances of the Commission's sample of comparable entities in section 3.1.3, and conclude that the firms from countries outside of western Europe and North America have materially higher cash balances (more than twice as a proportion of revenue) than the firms in North America and western Europe. Our view is that the higher levels of cash in the former countries most likely reflects a difference in financing strategy, reflecting the less mature financial markets in those regions, and so is not relevant to a calculation of ROACE.

52. In our calculation of ROACE for the comparable entities in Chapter 2, we have applied as our base case a calculation of ROACE for the comparable entities that include a normalised allowance for cash, reflecting the practice of the firms in western Europe and North America. In addition, we have calculated ROACE with cash removed from capital employed for both the comparable entities, and compared this to the Foodstuffs entities

with ROACE calculated on a consistent basis, and tested whether this would result in a different outcome.

### *Asset valuation – physical assets*

53. Given that the objective of the Commission is to assess the extent to which competition is working for the benefit of customers in the retail grocery market, the calculation of capital employed must (at least to the extent practicable) reflect the current market value of fungible assets, and the full replacement cost of specific assets. Valuing assets on this basis will replicate (again, at least to the extent that is practicable) the cost structure of a hypothetical efficient new entrant, which in our view is well accepted as the asset value that would be reflected in the market price that would be observed in a competitive market in (hypothetical) long run equilibrium,[28] albeit with actual market outcomes expected to vary around this point. Importantly, estimated long run outcomes will indicate the expected tendency of competitive markets; there is no reason to believe that a market with effective competition will be at long run equilibrium at a point in time.

54. We also agree with the Commission that it is appropriate, when measuring returns, to treat revaluation gains as income. To be clear, however, the revaluation gain that is relevant for any given year is the revaluation that arose (or was expected to arise) within the year in question. It is inappropriate to attribute part or all of the revaluation gain that was accrued in past periods – past period revaluation gains create (economic) income in those past periods, not in the current period.

    a. We are aware that the spike in the FSNI cooperative centre's ROACE for FY2019 is associated with the gain on sale of an asset, with that gain reflecting the entire revaluation gain over the life of the asset (which had been purchased in the 1960s).

    b. Recognising the whole of the revaluation gain as income in 2019 was an error. Only the share of the revaluation gain that arose within 2019 should have been recognised in 2019, with the remainder of the revaluation gain being recognised in earlier years (back to the date at which the asset was purchased).

55. In relation to the assumption to be made about the revaluation gains associated with land and buildings assets, in our view, the most meaningful assumption is one that reflects the revaluation gains that parties reasonably would have anticipated, and that those parties reasonably would anticipate in the future.

    a. We acknowledge that, in practice, large positive revaluation gains may have occurred in some past years, and potentially large revaluation losses may have occurred in others, reflecting the fact that property prices tend to be volatile and hence unpredictable, at least in the short term.

    b. However, if actual revaluation gains are factored into the analysis of profitability, then the calculation may show large profits or losses, even though those outcomes

28 To be clear, however, the outcomes in any competitive market would be expected to vary around the long run equilibrium with changes in demand, entry/exit, consumer tastes and technology. The (hypothetical) long run equilibrium outcome merely reflects the point to which the forces of competition will push outcomes in markets where competition is effective.

were entirely unexpected by all parties and could not possibly have influenced how any party behaved. As the purpose of the Commission's analysis is to ascertain whether competition has been working to the benefit of customers, the more relevant questions are:

i. What revaluation gains would firms in a competitive market reasonably have factored into their past pricing behaviour?, and

ii. What returns would a new entrant into the sector have expected during the analysis period and/or now and, in turn, should these returns have been sufficient to encourage new entry?

c. In our view, applying an assumed revaluation gain that reflects what parties reasonably would have anticipated, and would anticipate today, would provide the most meaningful insight into these questions.

56. However, attempting to form a precise view on the likely magnitude of anticipated revaluation gains is a difficult task, for the following reasons.

a. First, the target is the combination of land as well as buildings, and the latter forms a material share. As shown in with the average share of buildings in the last seven developments across FSNI and FSSI averaging approximately 60 per cent (and ranging between approximately 30 per cent and 80 per cent, depending on the location).

**Table 3 – Share of land vs. buildings in recent supermarket developments**

| | Land (% land + buildings) | Buildings (% land + buildings) |
|---|---|---|
| **FSNI** | | |
| PNS Balmoral | 50% | 50% |
| PNS Wellington | 59% | 41% |
| PNS Te Rapa | 41% | 59% |
| PNS Highland Park | 69% | 31% |
| **Average - FSNI** | **55%** | **45%** |
| **FSSI** | | |
| PNS Queenstown | 31% | 69% |
| NW Ravenswood | 20% | 80% |
| NW Three Parks | 29% | 71% |
| **Average - FSSI** | **27%** | **73%** |
| **Average of FSNI and FSSI** | **41%** | **59%** |

*Source: Incenta analysis of information provided by FSNI and FSSI*

b. Secondly, in relation to land, its value over time is materially affected by government decisions in relation to land releases, planning decisions and zoning, as well as the combination of local factors (such as the strength of a local economy) and demographic trends.

c. Thirdly, in relation to the building component, whilst the value of the building component will be affected by changes in the cost of new construction, the value of the existing building stock will also be affected by physical depreciation, changes in the service-potential of new buildings (such as energy efficiency) that tend to depress the value of existing buildings, as well as the costs required to maintain a structure.

d. Fourthly, like all assets that have long duration cash flows, the combined value of land and buildings will be affected by movements in interest rates, with the fact that current interest rates are at historical lows likely to provide a depressing influence on future growth in value.

57. Out of the factors above, the one that is the most measurable and predictable is the cost of building works themselves. Our review of the evidence suggests that the growth in the most relevant elements of building costs for a grocery retailer have tracked very closely to the growth in CPI over the period during which the relevant capital goods price indices are available in New Zealand, as shown in Table 4 below.

**Table 4 – Building construction price inflation vs. the CPI**

| Item of capital equipment | Series start | Series end | Years | Startng index | Ending index | Annual price increase (%) |
|---|---|---|---|---|---|---|
| Shops and Offices | 1979Q4 | 2021Q2 | 41.5 | 368 | 1813 | **3.92%** |
| Warehouses, Factories | 1979Q4 | 2021Q2 | 41.5 | 358 | 2065 | **4.31%** |
| Earthmoving and Site Work | 1979Q4 | 2021Q2 | 41.5 | 345 | 1949 | **4.26%** |
| Land Clearing and Establishment | 1979Q4 | 2021Q2 | 41.5 | 346 | 1759 | **4.00%** |
| Consumer price index | 1979Q4 | 2021Q2 | 41.5 | 193 | 1082 | **4.24%** |

*Source: Capital goods price index and Consumer price index, Statistics NZ (downloaded from: http://infoshare.stats.govt.nz/, 3 September 2021)*

58. It is also understood that a facility recently sold by Foodstuffs NI generated a long-term revaluation gain equal to a compound annual gain of approximately [[redacted]] per cent, after accounting for capital works during the life of the asset, whereas the average growth in the CPI over the same period was several percentage points higher. Moreover, given that facility was located in a relatively central part of Auckland, the gain realised for that asset would be expected to be at the high end of what would be realised across the service areas of the cooperatives.

59. In view of the above, we would suggest applying as a base case the long-term forecast of CPI growth as a proxy for the expected rate of revaluation gain from land and building assets, but to test sensitivities around this. In terms of this forecast, we would recommend adopting an assumption of long-term CPI growth of [[redacted]] per cent ([[redacted]]), albeit noting that this is somewhat conservative as actual CPI has tracked materially below this over the last decade.

### *Asset valuation – intangible assets*

60. We note that there is a substantial financial economics literature in relation to the growing importance of intangible assets in modern corporations associated with prior investments in such things as organisation capability, internal processes and staff, but

which are typically not reported as assets in firms' financial accounts (the exception is where assets are traded and the value of such assets may be reflected in a "goodwill" asset).[29] Financial economics researchers Eisfeldt, Kim and Papanikolaou (2021), summarise the findings and implications of that literature in the following terms:[30]

*Intangible assets have become an important and fast-growing part of firms' capital stocks. Corrado, Hulten, and Sichel (2009) estimated intangibles to be about one third of the US non-residential capital stock in 2003,[31] while, using more recent data, Eisfeldt and Papanikolaou (2013b),[32] Falato, Kadyrzhanova, and Sim (2013),[33] Belo, Gala, Salomao, and Vitorino (2019),[34] and Ewens, Peters, and Wang (2020)[35] all estimate the contribution of intangible capital to overall corporate capital stocks to be around one half. In addition, these same studies report much higher investment rates for intangible assets relative to physical assets. The majority of intangible assets are created by investments in employee, brand, and knowledge capital that is expensed, and thus do not appear on corporate balance sheets. This has resulted in a growing mis-measurement of book assets.*

61. That is, the literature suggests that the true value of assets employed may be substantially higher than the assets that are recognised for accounting purposes. Accordingly, to the extent that returns are to be compared to an estimate of the WACC, a proper test would require an allowance for these omitted intangible assets.

62. For example, Peters and Taylor (2017) found that,[36] on average, over the years of their study (1975 to 2011):[37]

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29 Hall, Robert E., (2001), "The stock market and capital accumulation," *American Economic Review*, Vol. 91, pp.1185-1202.

30 Eisfeldt, Andrea, Edward T. Kim and Dimitris Papanikolaou (29, April, 2021), "Intangible Value", UCLA Anderson School of Management, Kellogg School of Management and NBER. To estimate the value of intangibles assets, Eisfeldt, Kim and Papanikolaou (2021, p.2) applied the same approach to measure the value of intangibles as Eisfeldt and Papanikolaou (2014) did:

*We follow the method introduced in Eisfeldt and Papanikolaou (2013b) to measure firm-level stocks of intangible assets. Specifically, we apply the perpetual inventory method to flows of Selling, General, and Administrative (SG&A) expenses, given assumptions about depreciation and initial values.*

31 Corrado, Carol, Charles Hulten, and Daniel Sichel. (2009), "Intangible capital and US economic growth," *Review of income and wealth*, Vol. 55(3), pp.661–685.

32 Eisfeldt, Andrea L., and Dimitris Papanikolaou, (May, 2014), "The value and ownership of intangible capital," *American Economic Review*, Vol.104(5), pp.189–94.

33 Antonio Falato, Dalida Kadyrzhanova, and Jae Sim, (September, 2013), Rising intangible capital, shrinking debt capacity, and the US corporate savings glut. Technical report, FEDS Working Paper, No. 2013-67.

34 Belo, Frederico, Vito Gala, Juliana Salomao, and Maria Ana Vitorino, (2019), "Decomposing firm value," Technical report, National Bureau of Economic Research.

35 Ewens, Michael, Ryan H Peters, and Sean Wang, (2020), "Measuring intangible capital with market prices," Technical report, URL https://papers.ssrn.com/sol3/ papers.cfm?abstract_id=3287437.

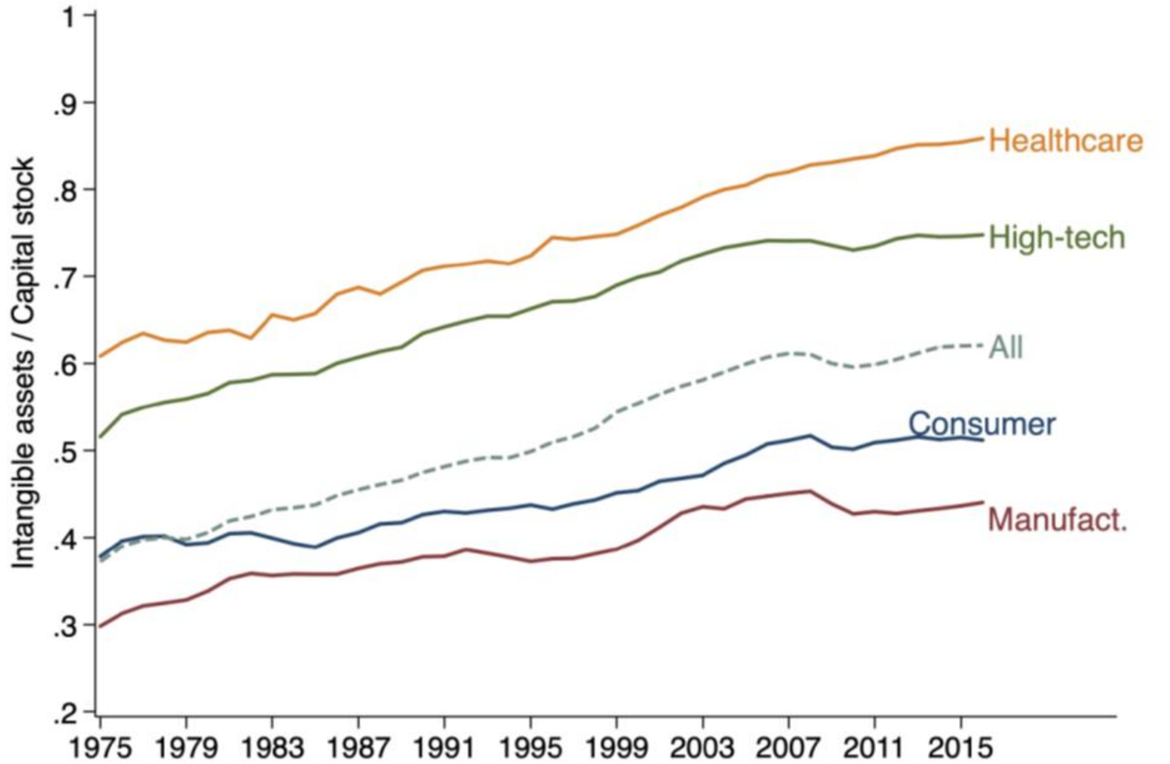
36 Peter and Taylor defined "intangible capital intensity" as the intangible assets of firms (including unbooked intangible assets) as a proportion of the total of the physical and intangible assets.

37 Peters, Ryan H., and Lucian A. Taylor, (2017), "Intangible capital and the investment-q relation", *Journal of Financial Economics*, Vol. 123, p.258.

*the mean (median) intangibles intensity is 43% (45%), so almost half of the capital is intangible in our typical firm year*

63. Figure 1 illustrates the growth in importance of intangible assets as calculated by Peters and Taylor, which they found by 2015 comprised approximately 50 per cent of the total capital stock of consumer industries, and much higher proportions of high-tech and healthcare (75 per cent to 85 per cent).

**Figure 1 – Intangible asset intensity over time (US)**




*Source: Peters and Taylor (2017), p.259*

64. More specifically, there is a growing literature discussing intangible assets in retail activities. For example, for the US retail sector, Crouzet and Eberly (2018) found that over the decades since 1990 the productivity per employee (e.g. sales per employee) was found to be rising rapidly, but: [38]

*While physical capital investment remained sluggish as productivity rose, intangible capital rose markedly … [and] …balance sheet intangible capital in the sector rose as acquisition values included a larger share of intangible assets.*

38 Crouzet, Nicolas and Janice Eberly, (May, 2018), "Intangibles, Investment, and Efficiency," *American Economic Review – Papers and Proceedings*, p429.

65. They concluded that the productivity growth in the absence of major physical capital investment was the return on increasing investments in intangibles such as brands, logistics and improved distribution networks.

66. In view of these findings, to the extent that returns are to be compared to an estimate of the WACC, a proper test would require:

a. an allowance for these omitted intangible assets, or

b. alternatively, if such an adjustment to capital employed is not made, then it must be recognised that the likely presence of intangible assets – but omission from capital employed – would be expected to result in returns being earned that are above the estimated WACC. This is because firms in competitive markets are able to earn a return on all assets that a new entrant would need to reproduce, irrespective of whether they are formally reported in firms' balance sheets.

   i. Consequently, a more robust test of whether the returns are excessive would come from a comparison of the returns of the Foodstuffs cooperatives to the returns observed for the international grocery retailers.

   ii. This is because, in both cases, the presence of intangible assets of the sort described above – but their omission from capital employed – would imply that the benchmark return (i.e., the return of international comparables) would also be a margin above WACC to reflect a return on these assets, and so provide a like-for-like comparison. We return to this issue in the next section.

### 2.2.5 The appropriate benchmark for ROACE

#### *Introduction*

67. As discussed above, the Commission's principal benchmark against which it tested the returns earned by the Foodstuffs entities was the Commission's estimate of the weighted average cost of capital (WACC) for a grocery retailing activity, although it also compared Foodstuffs' returns against the historical ROACE estimated for a sample of international grocery retailers and the historical ROACE estimated for the firms that are included within the NZX50.

68. In our view, the most appropriate benchmark for testing the returns for the Foodstuffs entities is the return measured over a reasonable historical period for a sample of international grocery retailers, and that substantial errors may arise in relation to the other bases for comparison. We address our concerns about comparisons against the WACC and the returns of the firms on the NZX50 in turn below.

#### *Comparisons against the WACC*

69. In relation to the WACC, as discussed above, a critical assumption with the use of this basis for comparison is that the capital employed is a comprehensive accounting of the economic assets that are required to undertake grocery retailing (and that a new entrant into this activity would need to replicate). However, as discussed above, there is

substantial evidence that a material share of the assets that firms create over time – and especially in sectors like grocery retailing where internal know-how is a key source of competitive advantage – is simply excluded from any measure of capital employed that is based on accounting data.

a. Thus, unless an allowance is made when calculating ROACE for the Foodstuffs entities to reflect these unbooked intangible assets, then even if the market within which the firm operated was vigorously competitive, a return that is systematically above WACC would be expected to reflect the return that would be permitted for the unbooked intangible assets. If a comparison is made against the WACC, this return on unbooked assets would be incorrectly interpreted as an excess return.

b. This concern is much reduced, however, if the returns for the entity being assessed is compared against the returns of international grocery retailers. This is because the returns of the firm being assessed and the benchmark against which it is being compared would both be expected to contain a similar upward bias, thus providing for a more appropriate comparison.

70. In addition, if a comparison is to be made against the WACC, a real and difficult issue arises as to the correct WACC to apply. There are at least two dimensions to our concern in this regard.

a. First, equally credentialled and independent experts can come up with materially different WACC estimates. I understand that Foodstuffs has received independent advice in relation to its WACC for business decision making purposes, and that the estimates it received were materially higher than the Commission's estimate, which serves to illustrate this potential.

b. Secondly, the objective of the Commission's exercise when testing the returns of Foodstuffs is to estimate the WACC that would be impounded into the market price in a market where there was effective competition, rather than the WACC that may be appropriate for deciding upon whether to invest at a particular point in time. There is, however, no reason to expect the price in competitive markets to quickly to reflect changes in interest rates. Rather, changes in interest rates would only be expected to flow through into competitive prices gradually over time through their influence on entry and exit decisions.[39] There are two observations that can be drawn from this.

i. First, today's prices would be expected to have a link to the expectations of investors about interest rates at the time that past decisions were made. This is significant because the interest rates reflected in the Commission's calculations are less than half of the rate that was seen as the norm a decade ago.[40]

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39 A further implication is that the WACC the Commission has estimated can be said to be appropriate for the outcomes flowing from investments made in recent years, but not for those made in the decades before.

40 As an indication of the materiality of this issue, the average yield on long term NZ government bonds in the two decades prior to the global financial crisis (September 2008) was approximately 6 per cent. If this interest rate were instead used, then the Commission's range for WACC would increase by approximately 2.5 percentage points.

ii. Secondly, a new entrant into the market would face a substantial irreversible component to its investment, and consequently would be expected to factor in their expectations about interest rates over the life of their investments (i.e., spanning a decade or more). There is no reason to expect, in our view, that such a new entrant would make investments premised on the assumption that the current very low interest rates continue for that period.

### *Comparison against the ROACE for NZX50 firms*

71. In estimating its measure of the average ROACE for the NZX50 Index (less three banks that were removed), the Commission has summed the values for ROACE component variables and in this way calculated a composite return for the period (6.9 per cent if each of the years from 2015 to 2019 is given equal weight). The Commission used this as an "NZX50 benchmark" against which it compared its WACC range, headline ROACEs it observed for the international comparators, and the Foodstuffs cooperatives at the retail level.

72. In our view, no economic meaning can be derived from a comparison of the returns for a grocery retailer against the average composite return for all firms listed on the NZX50. For a comparison of returns to have any validity, there must be a comparability between the activities of the firm being assessed and the benchmark, which the Commission has not established.

73. In Appendix C we provide a table (Table 10) showing the full breakdown of the major industry sectors comprising the NZX50 and the companies in each sector. The table shows a wide degree of variation in realised ROACEs during the 2015-19 period depending on the industry sector, and between firms within sectors. We further note that, compared to the return of 6.8 per cent that we calculated using the Commission's method (which was a weighted average, with "capital employed" applied as weights):

a. the simple average of ROACEs (which the Commission calculated for the international grocery retailers) would have implied an average ROACE of 2.4 per cent, and

b. a weighted average ROACE using enterprise value instead as weights (ENTERPRISE_VALUE in Bloomberg) would have implied an average ROACE of 7.8 per cent.

74. The large range in average returns depending on whether and how firms are weighted – and the absence of any strong rationale to prefer one form of average over the other – suggests that a comparison against the ROACE for the NZX50 firms does not provide a robust test of the returns of the Foodstuffs cooperatives.

75. In addition, we note that close to half of the firms in the NZX50 (according to the Commission's weights) is comprised of Fonterra Cooperative Group Ltd plus low risk utility and infrastructure firms, many of which (including Fonterra) are regulated and so would be expected to have relatively low ROACEs. Comparisons against the overall sample of firms, therefore, is not appropriate for the Foodstuffs cooperatives.

76. When we look at sectors that have a closer relationship to the activities and operations of the Foodstuffs' cooperatives, we find a different picture emerging. These sectors – and the simple average of ROACEs achieved over 2015-19 are:

a. Consumer Discretionary Products (13.6 per cent)

b. Consumer Staple Products (12.4 per cent, once Fonterra and A2 Milk are excluded)[41]

c. Industrial Services (transport) (11.5 per cent), and

d. Real Estate (9.3 per cent).

77. The returns observed in these sectors are very close to the average ROACEs of the Foodstuffs cooperatives over the same period.[42]

### 2.2.6 Other measures of profitability

#### *Internal rates of return in business plans*

78. The Commission has drawn two pieces of information from the companies' business plans, namely:

a. The IRR expected from projects (and the actual outcome, where available), and compared this to its own estimate of WACC, and

b. The hurdle rate applied by the firm when judging whether to proceed with projects, which again was compared with the Commission's own estimate of WACC.

79. First and foremost, we note that for the Foodstuffs cooperatives, the only IRR that can be ascribed any economic meaning is the IRR that is projected for the whole of business. This is based on our understanding that investment decisions are made on the basis of the projected whole of business return, and that the other assessments (such as the IRR that is calculated for the store level) is undertaken to test whether the store will be sufficiently profitable to attract a store owner (or, alternatively, excessively profitable), either of which may then be corrected through an adjustment to the rent that is payable by the store to the centre. That is, the IRRs below the level of the whole of business are undertaken only to determine the sharing of the benefits from a new investment within the cooperative, rather than whether an investment will take place. Thus, these latter IRRs have no relevance to an assessment of whether excess returns may be expected.

80. In relation to the IRR that is expected in business cases, we do not think the expected IRR from an incremental project will provide meaningful evidence about whether excessive returns may be expected. Where incremental projects are evaluated correctly, only future revenues and expenses are considered, and sunk or fixed costs – like spare capacity in distribution centres and the capability of the cooperative centres – are

41 We view Fonterra as more akin to an infrastructure firm given the regulated nature of its operations. A2 Milk made an average ROACE over this period of 43.7 per cent.

42 The average ROACEs for FSNI and FSSI over the same period were 9.2 per cent and 11.5 per cent, respectively – see section 3.4.

ignored. Thus, it would be unremarkable for even the majority of business cases to show an expected IRR that looks excessive; however, when combined with the sunk or fixed costs that are ignored in those business cases, may be reasonable.

81. In relation to the IRR that is applied as a hurdle rate, we think it is important for the Commission to give weight to how those hurdle rates have been derived, rather than simply to compare the hurdle rate to the Commission's estimate of the WACC, given the potential for equally qualified experts to reach a materially different conclusion as to the WACC. Our understanding is that the cooperatives' hurdle rates are the product of independent advice from experts that was provided to assist with business decision making, and that the experts' estimates of WACC have been applied to judge the worth of investments without any further margin (or hurdle) being applied. Such a process would not suggest that the hurdle rates applied embody an excessive return.

### *Profit margins*

82. As noted above, the Commission has reported the results of three profit margins for Foodstuffs (gross profit margin, EBIT margin and NPAT margin), which it has calculated at the store level, and compared these to the equivalent profit margins earned by the international comparable entities.

83. In our view, the benchmarking of profit margins has some desirable attributes – in particular, these measures of financial performance are less likely to be influenced by accounting practices. However, benchmarking of profit margins also has shortcomings as there is less account taken of the potential for the cost of undertaking grocery retailing to differ between providers and/or geographies. These factors are important to consider when assigning weight to this form of evidence.

84. In terms of the Commission's analysis, in our view it would be more appropriate for the profit margins to be calculated on a whole of business basis, for the reasons that we have provided above in section 2.2.3. Moreover, the Commission noted that the profit margins that it calculated for the Foodstuffs stores may be biased downwards (gross profit margin) or upwards (NPAT margins) due to the intra-firm payments being either greater than or less than the economic cost of the activities performed. This concern is eliminated when profit margins are calculated at the whole of business levels for the cooperatives.

85. In terms of the specific margin measures applied, we agree with the use of the gross profit margin (although we have a concern with the margins that are calculated for UK firms – we discuss this issue in section 3.3.1). However, we do not think that either the EBIT margin or NPAT margin should be applied by the Commission, for the following reasons.

a. *EBIT margin* – as discussed in section 2.2.2, the EBIT margin that is reported for a firm will be affected by the firm's choice over whether to rent or own assets (although this concern will fall away where returns are reported under IFRS 16). As shown in that section, a firm that chooses to own its assets will be found to have a much higher EBIT margin that a firm that chooses to rent its assets, even though those firms were otherwise identical. In the case of Foodstuffs, as the cooperatives own most of their assets, but the sample of international comparable entities contains firms that, on average, rent some of their assets (approximately 34 per cent on average), the EBIT margin benchmarks (unless adjustments are made) will be too low to be applied to Foodstuffs.

b. *NPAT margin* – this margin is sensitive to the degree of financial leverage that firms possess, and so cannot be applied to a firm with a different level of financial leverage unless an adjustment is made for the difference in leverage (that is, if such an adjustment is not made, then the comparison is economically meaningless). In our view, there is little merit in attempting such an adjustment.

86. An alternative profitability indicator that we recommend the Commission should consider is "earnings before interest, tax, depreciation, amortisation and rent" (EBITDAR) expressed as a proportion of revenue. As this indicator is calculated on a pre-rent basis, it is unaffected by the change in accounting standards with respect to leases. Moreover:

a. as the margin is determined on a pre-rent basis, it is a truly pre-financing measure, as renting is included as a source of finance, and

b. as the margin is determined on a pre-depreciation basis, it is independent of the accounting treatment of assets.

## 2.3 Weight to apply to profitability assessments in competition analysis

87. As noted above, a consequence of addressing the matters discussed above – and dealing with the implicit leverage associated with renting of assets in particular – is that the evidence that the NZ grocery retailers have earned excess returns is weakened substantially. As a consequence, it becomes necessary to consider explicitly the conditions under which it can be concluded that there is evidence of excess returns. That is, how much of a diversion from "normal" is required, and or how long must it persist before a judgement of excess returns can be made?

88. We observe that there are substantial challenges with using measured profitability to infer whether competition is effective. There are three different contributors to this.

a. First, the measurement of profitability itself, and the derivation of appropriate benchmarks for a normal level of profitability, faces substantial empirical challenges, a number of which have been discussed above. Accordingly, there is a real risk that false inferences may be drawn.

b. Secondly, even putting aside the measurement issues, the generation of a "normal return" is a long run equilibrium outcome of a competitive market, and hence is the outcome to which a market should tend as a consequence of the competitive process, around which the outcomes observed in a real-world competitive market may diverge from substantially at any point in time. Indeed, the Commission has commented previously on the limited importance of long run equilibrium outcomes for explaining the (market) value of assets in competitive markets, as follows:[43]

*While the Commission agrees that workably competitive markets will tend towards equilibrium over time, asset values in these markets are not defined by a long-run equilibrium. J. M. Clark is the academic widely credited with first distinguishing workable competition from other traditional economic models of competition (refer Chapter 2). He noted that in workably competitive markets, "tendencies towards equilibrium ... never reach their static limits". So in workably competitive markets, long-run equilibrium is unlikely to be reached, shortages and surpluses continuously arise and outcomes constantly evolve. Asset values in particular vary in light of changing expectations about the future, not simply in light of changes in replacement costs today.*

*Empirical evidence supports this conclusion. It demonstrates that while asset values in workably competitive markets characterised by specialised assets may occasionally converge with replacement costs, they only very rarely if ever equate and will normally diverge by a significant amount for a prolonged period of time, including in some cases indefinitely. The extent and duration of any deviation will be influenced by, amongst other things, any arrangements that have shaped the relationship between suppliers and their consumers.*

c. Thirdly, even where profitability is considered over a period that is long enough to allow for the effect of competitive responses to be felt (including entry and exit), firms may still earn a return above a level that is "normal" where the firm has superior efficiency to competitors (including through a superior product) and where competitors have not been able to replicate that advantage.

89. We observe that the factors above have led some competition authorities and commentators to question whether any reliable information may be drawn from measured profitability. For example:[44]

*The economic and legal literature, while generally supportive of the logic behind the use of profitability estimates, has in general been rather sceptical about the use of profitability data as evidence of substantial market power. Judge Posner, for example, declared:*

> *It is always treacherous to try to infer monopoly power from a high rate of return. ... Not only do measured rates of return reflect accounting conventions more than they do real profits (or losses), but there is not even a good economic theory that associates monopoly power with a high rate of return. [Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic, 65 F.3d 1406 (7th Cir. 1995)].*

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43 Commerce Commission (2010), Inputs Methodologies for the EDBs, December, para.4.3.60-4.3.61, and cited by the High Court of New Zealand (Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC [11 December 2013], para.521).

44 OECD Competition Committee, *Evidentiary issues in proving dominance*, Competition policy roundtables, 2006, p 40.

90. Similarly, Bork and Sidak have commented as follows:[45]

*Neither economic theory nor empirical evidence indicates a dispositive relationship between profit margins and the possession of market power.*

91. Presumably in light of these factors, profitability assessments are not commonly applied in competition policy around the world, with the UK being a notable exception.[46]

92. Where profitability assessments are applied as a tool for testing the degree of competition, a common theme is that three elements are required before any inference can be drawn from measured profitability. These elements are that:

a. the difference between measured profitability and "normal" profitability should be "unequivocally substantial",[47] or "significant"[48]

b. the profitability gap referred to above must be persistent and, more specifically, endure over a sufficient period to account for fluctuations in the business cycle and investment outcomes,[49] and

c. for there to be confidence that the observed returns cannot be explained by superior performance.[50]

93. We return to the first two of these elements when discussing the profitability results for the Foodstuffs cooperatives in section 3.4. We note here that, of these elements, the one that is most challenging for the assessment of the Foodstuffs cooperatives is whether the difference between their returns and normal returns is "unequivocally substantial" or "significant", which in our view cannot be concluded from the evidence.

94. Lastly, we observe that our discussion above assumes, implicitly, that the returns of the cooperatives are to be benchmarked against that of the international grocery retailers, and so the material errors we identified with benchmarking against an estimated WACC had already been eliminated. To the extent that the cooperatives' returns nonetheless were to

45 Bork, R H and Sidak, J G, *The misuse of profit margins to infer market power*, Journal of Competition Law and Economics, 9(3), 2013, p 512.

46 OXERA, *Assessing profitability in competition policy analysis*, A report prepared for the Office of Fair Trading by Oxera, July 2003, p 27.

47 Competition Commission, *Guidelines for market investigations: Their role, procedures, assessment and remedies*, April 2013, para 122, where the Commission notes that "[i]n cases where a persistent gap is not unequivocally substantial, it is particularly important for the CC to consider the analysis in conjunction with other information about the operation and nature of the market concerned".

48 OFT, *Assessment of market power: Understanding competition law*, Competition law guideline, 2004, para 6.6. Oxera, in a discussion paper for the OFT, opined that profitability estimates must be robust and their divergence from a relevant benchmark must be statistically significant, although it noted that the question 'how excessive is excessive?' cannot be answered clearly (OXERA, *Assessing profitability in competition policy analysis*, A report prepared for the Office of Fair Trading by Oxera, July 2003, p 124).

49 Competition Commission, *Guidelines for market investigations: Their role, procedures, assessment and remedies*, April 2013, para 121.

50 See, for example, OECD Competition Committee, *Evidentiary issues in proving dominance*, Competition Policy Roundtables, 2006, p 41.

be benchmarked against an estimated WACC, then an even large divergence from "normal" would be required to account for the additional risk of error.

# 3. Profitability benchmarks

## 3.1 Methodological issues

### 3.1.1 The sample of comparable entities

95. The Commission applied search criteria in Bloomberg to derive a large sample (30) of overseas firms whose principal activities were a retail grocery service. We have reviewed the Commission's sample and, with one exception, agree with the firms the Commission has found.

96. The one exception relates to Casino Guichard Perrachon SA (Casino) and Rallye SA.[51] From our examination of the firms, it is clear that Rallye SA is a holding company whose revenue and expenses are virtually the same are Casino, and Casino is the operating company (amongst other things, all of the grocery retailing senior managers are employed by Casino). Thus, including both of these entities in the sample results in a double-counting of an observation, and so we have included Casino (being the operating company) and excluded Rallye SA, leaving a main sample of 29 firms.

97. In addition, we have excluded the following firms from specific profitability benchmark estimates:

   a. Return on capital employed – we have excluded the three firms that have a negative Capital Employed and ROACEs that return highly unstable and "not meaningful results", which we discuss further below.

   b. Gross profit margins – we have calculated the margins with all firms included as well as excluding the UK firms, given our suspicion that the latter report a higher proportion of their operating expenditure as part of "cost of goods sold" than firms in other countries, which makes their measured gross profit margins less comparable.

### 3.1.2 Minor corrections to the Commission's profitability estimates

98. We received a spreadsheet from the Commission showing the individual ROACE calculations for each year (2002 to 2019) for every firm in its international comparator group sample, as well as a list of Bloomberg fields used. Aside from the changes in method that we explain below, we have also made several minor changes to the Commission's calculations, as follows:

   a. The Commission has calculated several ROACEs with only one Capital Employed number rather than two, resulting in an approximate halving of the reported average capital employed. Where opening and closing information is not available, we have omitted the observation.

   b. We have applied a more comprehensive measure of short term interest bearing liabilities, noting that the Commission's selected Bloomberg field

[51] Bloomberg tickers CO FP Equity and RAL FP Equity respectively.

(BS_ST_PORTION_LT_DEBT) omits the component of short-term debt that is not the short-term portion of long-term debt.

c. The Commission's calculations included observations from two firms for whom the capital employed was often negative, so that measured returns were non-meaningful. These were two of the three firms discussed above that we have excluded from our ROACE estimates.

99. The effect of the changes above worked in opposite directions, with the net effect not being material,[52] with only a very slight reduction in the average ROACE (with all cash included in capital employed, the average ROACE for 2015-19 falls from 11.3 per cent to 11.2 per cent).[53]

### 3.1.3 Benchmarking of cash holdings

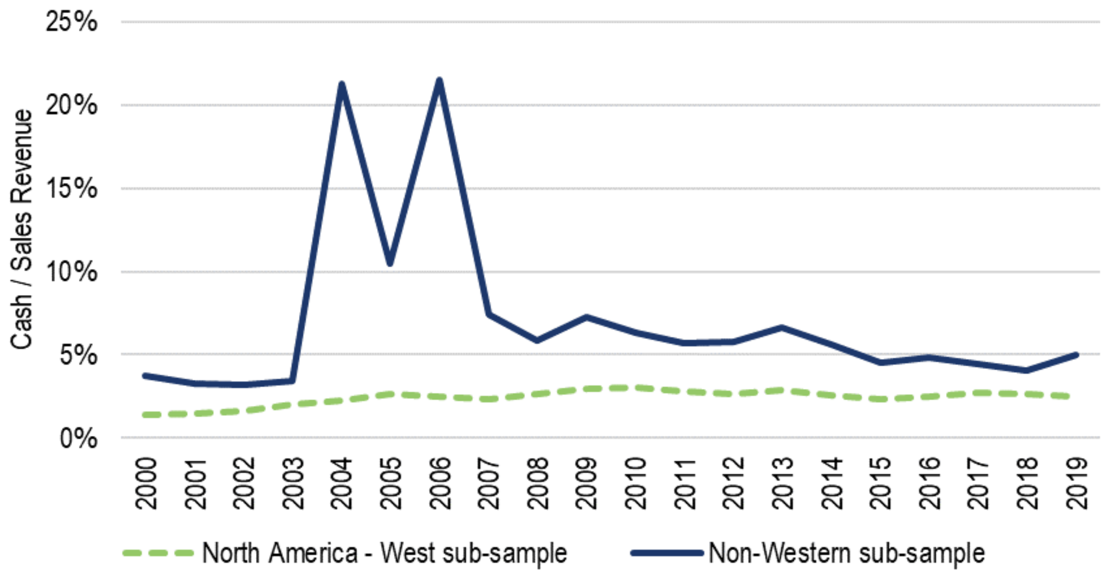
100. As discussed earlier, caution is required in the treatment of cash when estimating ROACE. This is because, if some companies hold material cash balances for purposes that are unrelated to a NZ grocery retailing operation, then including those cash balances when calculating ROACE will create a point of comparison that is invalid. Some form of normalisation of cash balances is required.

101. Figure 2 below shows our analysis of the cash balances for the international grocery retailers, where we break down the sample between the firms operating in western Europe / North America / Australia (the ("West") from the remainder ("non-West"). We found that the non-West firms held cash balances that were double or more relative to sales than the West firms. Specifically, during the 2015-19 period the non-West sub-sample held cash balances equal to 5.1 per cent of their revenue, whereas the West sub-sample held cash balances of only 2.5 per cent of their revenue. The two Foodstuffs cooperatives' cash balances were also very close to the West sub-sample.as a proportion of sales is close to the Commission's West sub-sample.

52 If all firms are left in the calculation, cash is unadjusted (and no other adjustments are made), then the 11.3 per cent the Commission reported would fall to 11.2 per cent. However, our exclusion of Rallye SE raises the average back to 11.3 per cent.

53 As noted above, this does not include issue of mixing ROACEs that are calculated under different accounting standards during the 2018-2019 years when a number of firms in the Commission's sample adopted IFRS 16 or ASC 842.

**Figure 2 – Cash as a percentage of Sales Revenue (2000-19)**




*Source: Bloomberg and Incenta analysis*

102. The marked differentials in cash holdings imply that other things being equal, firms in the non-West sub-sample would have a lower calculated ROACE, but which in our view is unlikely to be relevant to a NZ grocery retailing activity. Our hypothesis is that the higher cash balances are held in the non-West firms due to their presence in countries with less developed financial markets, and so as a protection against the additional liquidity risk.

103. In our calculations below we have adjusted the cash balances for the non-West firms so that their balances equate to 2.5 per cent their revenue, and thus match the average of the West firms. However, we also test the effects of excluding cash entirely from the calculation of ROACE.

### 3.1.4 Adjusting for the extent of ownership vs renting

104. Figure 2 below displays the level of ownership vs rental among the Commission's comparator set, and for context, compares this against the level of ownership observed for the two major Foodstuffs businesses. We can do this only for FY2020 because it is the first year that all firms have reported under IFRS 16, although a number of firms started reporting in the two years before that.

105. The definition of ownership that we have applied is:

$$Ownership\ level\ = \frac{Capital\ Employed\ (pre - IFRS16)}{Right\ to\ Use\ Assets + Capital\ Employed\ (pre - IFRS16)}$$

106. Figure 3 shows the diversity of ownership among the Commission's international comparator group ranges from close to 100 per cent to negative values. The two

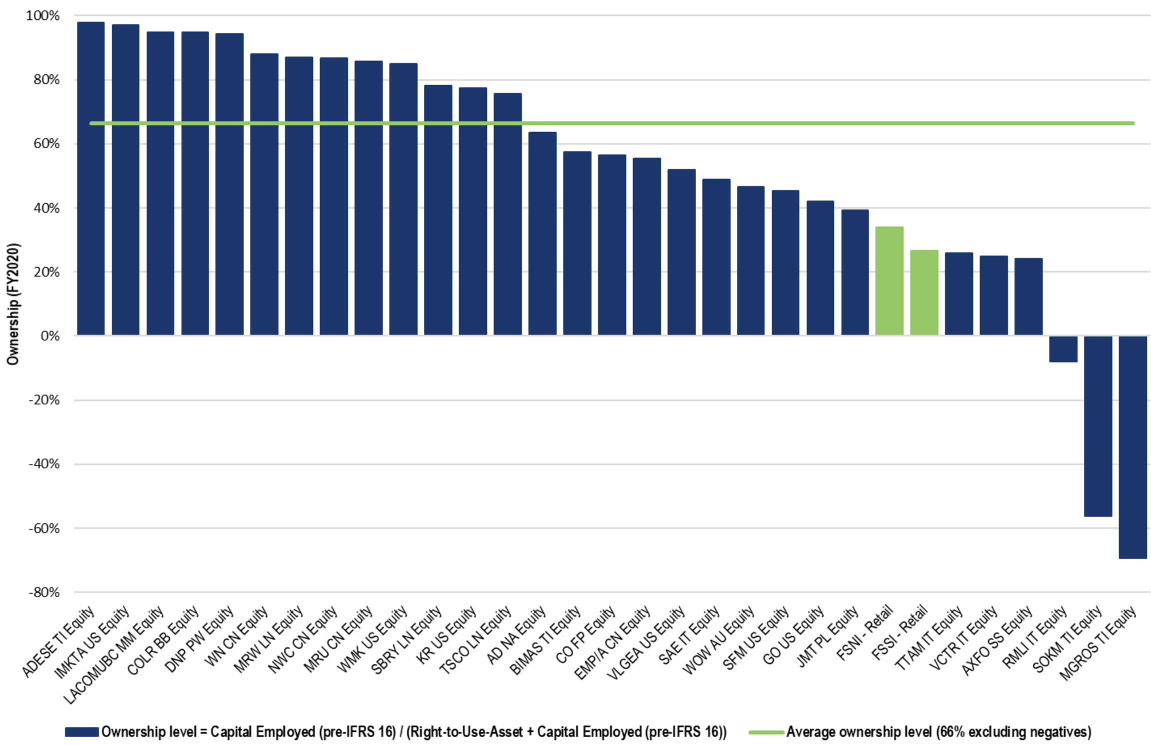
Foodstuffs businesses (FSNI – Retail and FSSI – Retail) had FY2020 ownership levels of 34 per cent and 27 per cent respectively, which places them at the lower end of the spectrum of ownership levels observed, and well below the 66 per cent average for that group (excluding the negative values). On this characteristic, the retail businesses are materially different from the average of the comparator group.

107. An ownership level of 66 per cent is the implicit level of ownership that the Commission has benchmarked Foodstuffs against. However, as noted earlier, we see that Foodstuffs has:

a. Approximately half the level of ownership – i.e., twice the level of gearing – of the Commission's sample, and

b. Therefore, it is invalid to benchmark the returns of Foodstuffs' stores – if they are assumed to be renters – against the Commission's entire sample of comparator entities.

**Figure 3 – Ownership level in the Commissions' sample of international firms, 2020**




*Source: Bloomberg and Incenta analysis*

108. In section 2.2.2 we explained how an adjustment may be made to account for the extent of "hidden leverage" where returns are measured on a pre-IFRS basis, which can be used to derive the return assuming an owner or for any desired level of renting.

109. Appendix B provides the comprehensive list of assumptions we have made to operationalise our estimation of the ROACEs that correspond to 100 per cent ownership

or any other nominated percentage ownership of assets depending on the headline return observed in each year.

110. The most critical assumption we have made is that the ownership proportions observed in 2020 (being the first year when all firms reported their right to use assets / lease liabilities) had been approximately constant since 2000. We confirmed that this is a reasonable assumption by calculating a "rental obligation to Capital Employed ratio" based on the sum of future rental payments that are reported in financial accounts.[54] That ratio was found to be relatively stable in a range of 65 per cent to 75 per cent over the period since 2000, and particularly stable at approximately 66 per cent in the 2015-19 period. We would therefore also expect the ownership ratio to have stayed relatively constant over that period.

111. A further key assumption required to implement this formula is what we refer to as the implicit rental interest rate, which is the discount rate that is implicit in the calculation of rental amounts. Our principal assumption for this input is that this implicit interest rate is equal to the relevant firms' standard borrowing costs, for which we have assumed that a 10-year BBB bond yield is an appropriate proxy. We have selected this interest rate because this aligns with the evidence of the interest rate that the international grocery retailers have applied to estimate the value of Right of Use Assets and the corresponding Lease Liabilities as required under the new accounting standards.

112. For example, Australia's Coles 2020 Annual Report states that:[55]

*If the Group cannot readily determine the interest rate implicit in the lease, it uses its incremental borrowing rate (IBR) to measure lease liabilities. The IBR is the rate of interest that the Group would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. The IBR requires estimation when no observable rates are available or when adjustments need to be made to reflect the terms and conditions of the lease. The Group estimates the IBR using observable market inputs when available and is required to make certain estimates specific to the Group (such as credit risk).*

113. The George Weston 2020 Annual Report states that:[56]

*In determining the carrying amount of right-of-use assets and lease liabilities, the Company is required to estimate the incremental borrowing rate specific to each leased asset or portfolio of leased assets if the interest rate implicit in the lease is not readily*

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54 The ratio we calculated was: Capital Employed (pre-IFRS16) / (Future Minimum Operating Lease Obligations + Capital Employed (pre-IFRS16)), where the operating lease obligations were downloaded from Bloomberg (BS_FUTURE_MIN_OPER_LEASE_OBLIG). As noted in the Woolworths (WOW AU Equity) 2016 Annual Report at p.98: "The Group leases retail premises and warehousing facilities which are generally for periods up to 40 years. The operating lease commitments include leases for the Norwest office and distribution centres. Generally the lease agreements are for initial terms of between five and 25 years and most include multiple renewal options for additional five to 10 year terms."

55 Coles Limited (2020) *Annual Report*, p.120.

56 George Weston (2020) *Annual Report*, pp.73-74.

*determined. Management determines the incremental borrowing rate using a base risk-free interest rate estimated by reference to the Government of Canada bond yield with an adjustment that reflects the Company's credit rating, the security, lease term and value of the underlying leased asset, and the economic environment in which the leased asset operates. The incremental borrowing rates are subject to change due to changes in the business and macroeconomic environment.*

114. However, in view of the importance of this assumption, we also show below the effect of assuming a higher implicit lease interest cost (namely, a 2 percentage point increment, pre-tax).

## 3.2 Estimated ROACE for the international grocery retailers

### 3.2.1 Base case results

115. Our estimates of the return on average capital employed for the sample of international comparable entities is set out in Figure 4 below. This figure shows the time series of the annual average return (i.e., averaged across the sample each year) since 2000 (a 20 year period ending with financial year 2019), for three measures:

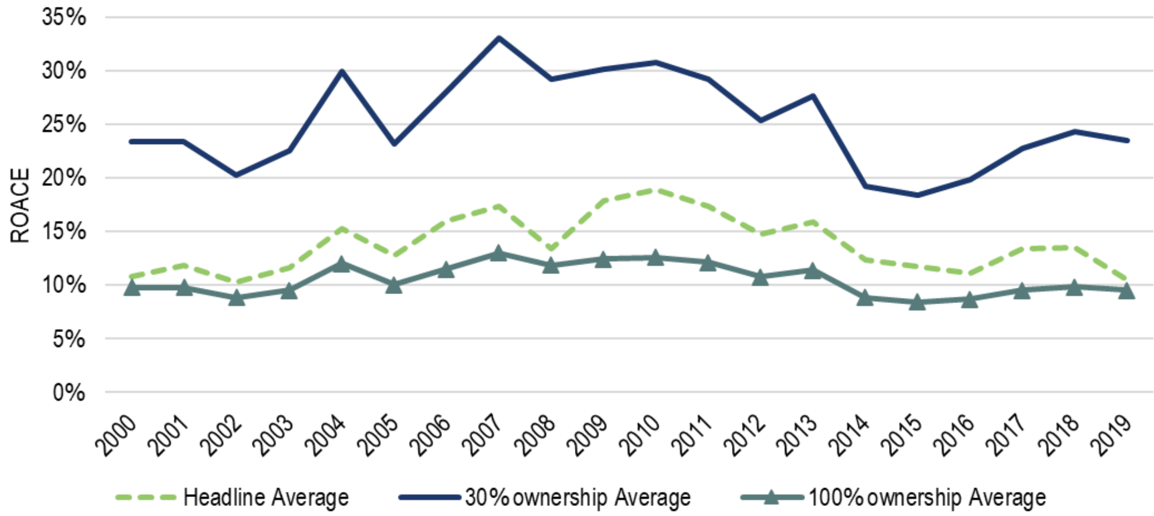
a. reflecting the headline return, which is simply the return that is consistent with the relevant firm's accounts in the year in question under the then-prevailing accounting standards

b. reflecting the return that we estimate the firms would have reported if they had been the owners of the assets they employ rather than a renter of proportion of their assets, and

c. reflecting the return that we estimate the firms would have reported if they had rented 70 per cent of the assets they employ, corresponding to the approximate level of renting the Commission assumed in its calculations for the Foodstuffs entities.

116. A summary table shows the averages of the annual averages over three different periods, namely the 5 years to 2019, the 10 years to 2019 and the 20 years to 2019.

**Figure 4 – ROACE by level of ownership, 2000 to 2019**




| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| Headline - Average | 13.8% | 14.0% | 12.1% |
| 100% ownership - Average | 10.5% | 10.2% | 9.2% |
| 30% ownership - Average | 25.2% | 24.1% | 21.8% |

*Source: Bloomberg and Incenta analysis*

117. From this chart, it can be seen that:

a. if 100 per cent ownership is assumed, which would be the case for Foodstuffs on a whole of business basis, the average return for the group of international grocery retailers is between approximately 9 per cent and 11 per cent depending on the period over which the average is calculated, and

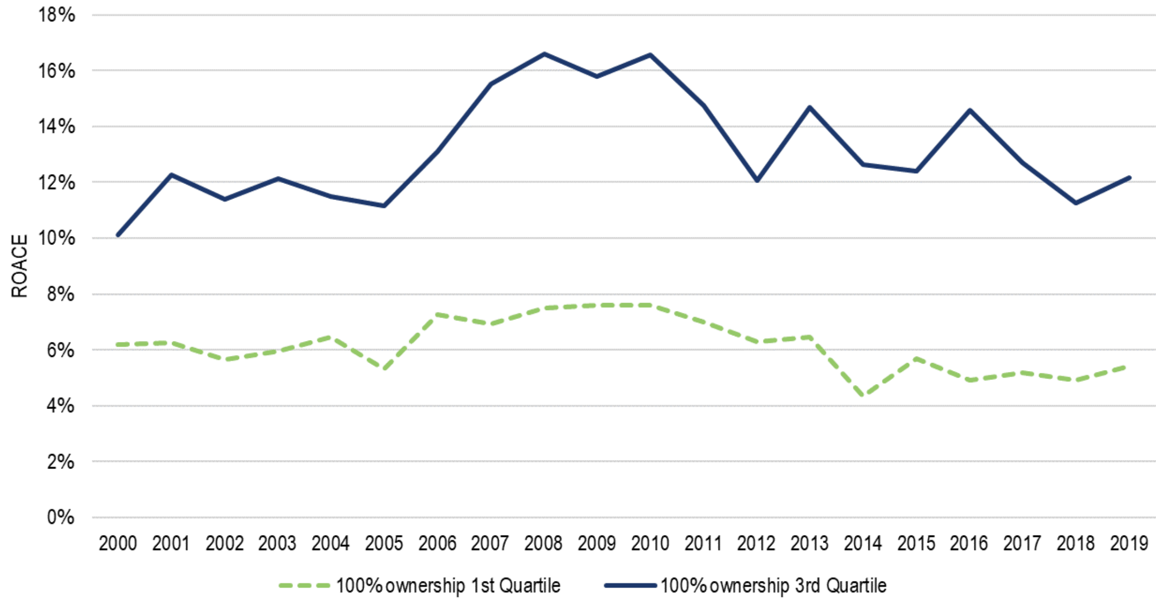
b. if a renter with a target 30 per cent ownership is assumed, reflecting the approximate mid-point "ownership" of the FSNI – Retail and FSSI – Retail businesses,[57] the average return for the group of international grocery retailers is between approximately is between approximately 22 per cent and 25 per cent, again depending on the period over which the average is calculated.

118. One other observation can be drawn from Figure 4. The "headline" return appears to show a material reduction in returns in 2018 and 2019; however, the same trend is not as marked (or obvious at all) in our estimates that adjust for the degree of ownership. The reason for this is that much of the downward trend that appeared in the headline numbers for 2018 and 2019 was due to firms that adopted the new lease accounting standards early – and so reduced their "headline" returns – rather than a real change to the profitability to the firms.

57 As noted above, the ownership levels of the FSNI – Retail and FSSI – Retail businesses are respectively approximately 34 per cent and 27 per cent.

119. Whilst the time-trend of the average of the sample moves within a fairly narrow band over time, a wide dispersion in outcomes is observed across the sample of firms in any year. This dispersion is illustrated in Figure 5, which shows the interquartile range of returns in each given year across the sample. The interquartile range shows the range of returns within which the return for half of the firms fell within the particular year, with the remaining half either above or below these limits.

**Figure 5 – ROACE: interquartile range for 100 per cent ownership, 2000 to 2019**




| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| 1st Quartile - Average | 6.2% | 5.8% | 5.2% |
| 3rd Quartile - Average | 13.2% | 13.4% | 12.6% |

*Source: Bloomberg and Incenta analysis*

120. This shows that, whilst the average returns for the sample ranges between approximately 9 and 11 per cent depending on the averaging period, the average interquartile range was between approximately 5 per cent and 13 per cent depending on the period over which the average is taken. Thus, the apparent constancy in the average annual return across the group of international grocery retailers masked material variation in performance across the firms.

121. An alternative measure of the dispersion of returns across firms can be derived by calculating the average return over a historical period for each of the firms, and observing its range. A summary of the distribution of the 10 year average returns for the sample of international grocery retailers is provided in Table 5.

**Table 5 – Inter-quartile range of 10-year average returns (100 per cent ownership)**

| | 1st Quartile | Average | 3rd Quartile |
|---|---|---|---|
| ROACE 2010-19 | 5.0% | 10.1% | 12.5% |

*Source: Bloomberg and Incenta analysis*

122. This alternative measure of the dispersion of returns provides a similar picture to the earlier discussion. That is, whilst the average of each firm's 10 year average return (2010-19) is 10.1 per cent, the interquartile range for the 10 year average returns was approximately 5 per cent to 13 per cent.

## 3.2.2 Sensitivities tested

### *Alternative treatments of cash*

123. As discussed in section 2.2.4, we set out two alternative methods for ensuring an appropriate treatment of cash when benchmarking ROACE for the Foodstuffs cooperatives against the international grocery retailers:

a. leaving cash in the calculation of capital employed, but removing excessive cash balances, or

b. removing cash from the calculation of capital employed entirely.

124. We have applied the first of these choices as the base case in the previous section. Table 6 below shows the effect of removing cash entirely from the calculation of ROACE for the sample of international grocery retailers, against which it would be appropriate to compare the ROACE for the Foodstuffs entities calculated on a comparable basis.

**Table 6 – Sensitivity of ROACE to the treatment of cash (100% ownership)**

| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| **Base case - Normalised cash** | | | |
| Headline - Average | 13.8% | 14.0% | 12.1% |
| 100% ownership - Average | 10.5% | 10.2% | 9.2% |
| **Cash removed from Capital Employed** | | | |
| Headline - Average | 15.6% | 16.0% | 14.0% |
| 100% ownership - Average | 11.1% | 10.8% | 9.6% |
| **All cash left in Capital Employed** | | | |
| Headline - Average | 12.8% | 12.8% | 11.3% |
| 100% ownership - Average | 10.1% | 9.7% | 8.8% |

*Source: Bloomberg and Incenta analysis*

125. This table shows that if cash is removed from capital employed, the ROACE for the international grocery retailers increases by 0.4 per cent to 0.6 per cent, depending on the historical period over which the average is calculated. We compare this to the movement in the ROACE for the Foodstuffs cooperatives in section 3.4.

126. Table 6 also shows for completeness the ROACE for the sample of international grocery retailers that would be calculated if all of the cash was left in capital employed. Comparing these figures to our base case results, it can be seen that the removal of excess cash from the non-western Europe / US firms resulted in an increase in the estimated ROACE for the international grocery retailers of approximately 0.4 per cent to 0.5 per cent.

***Sensitivity in relation to the implicit rental interest rate***

127. We also noted above that a key assumption in the method we applied to adjust (de-lever) our ROACE estimates to eliminate the effect of renting (or, more specifically, to align the return results with IFRS 16 reporting) was the interest rate that is implicit in the rentals on assets that are leased. The interest rate that we applied is essentially the marginal borrowing cost for the firms in question, following the assumptions made by international grocery retailers when estimating their own lease liabilities to comply with the new lease accounting standards. However, there is a chance that this assumption may understate the correct value, given that in principle the implicit lease interest rate should reflect the cost of capital associated with the asset leasing activity. Accordingly, as a sensitivity, Table 7 shows the effect of adding 2 percentage points (pre-tax) to our estimate of the lease interest rates.

**Table 7 – ROACE with lease interest cost sensitivity (lease interest cost +200bp)**

| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| Headline - Average | 13.8% | 14.0% | 12.1% |
| 100% ownership - Average | 11.0% | 10.6% | 9.7% |
| 30% ownership - Average | 23.4% | 22.3% | 19.9% |

*Source: Bloomberg and Incenta analysis*

128. The results in this table show that increasing the assumed lease interest cost has the effect of reducing the adjustment that is made to remove the levering effect of renting, so that the return estimated for an owner of assets increases while the return based on the assumption of largely renters of assets falls. However, the changes are not large – the significant increase in the assumed lease interest rates adds only 0.4 per cent to 0.5 per cent to the base case results. We therefore conclude that our results are reasonably robust to modest changes in the assumed lease interest rates.

## 3.3 Estimates of other measures of profitability

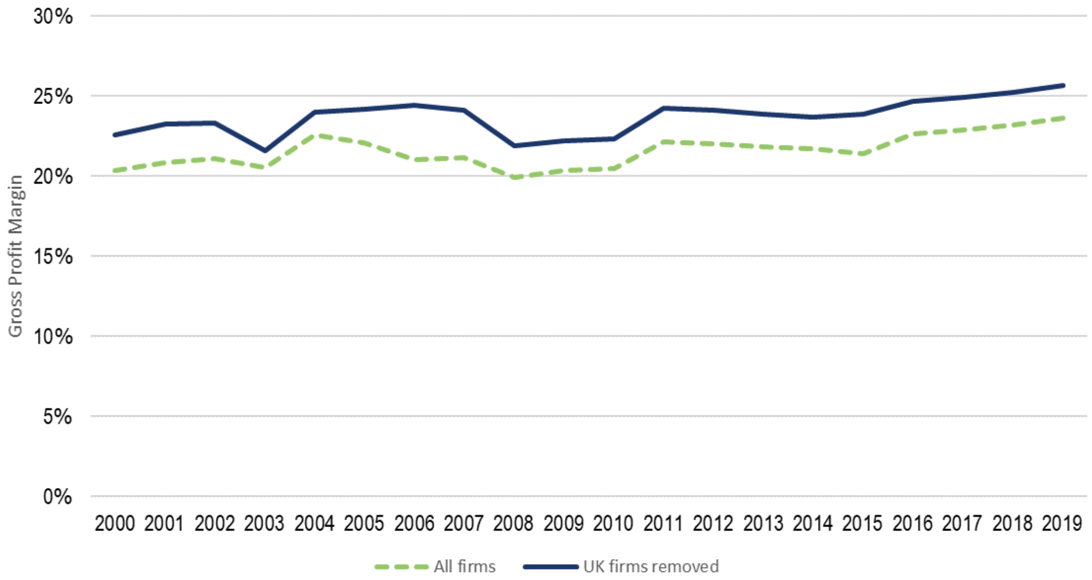
### 3.3.1 Gross profit margin

129. With regard to the Gross Profit margin (or GP margin, which is Cost of Goods Sold (COGS) / Revenue), for the 2010 to 2019 period the Commission calculated a value of 22 per cent for its sample of international grocery retailers.

130. In Figure 6 below, we display our findings for the sample of international grocery retailers. Across the whole of the sample, we found that the gross profit margin averaged around 22 per cent, irrespective of the period over which the average was derived. These

results are essentially the same as those the Commission reported (the only difference being the effect of excluding Rallye SA for the reasons set out earlier).

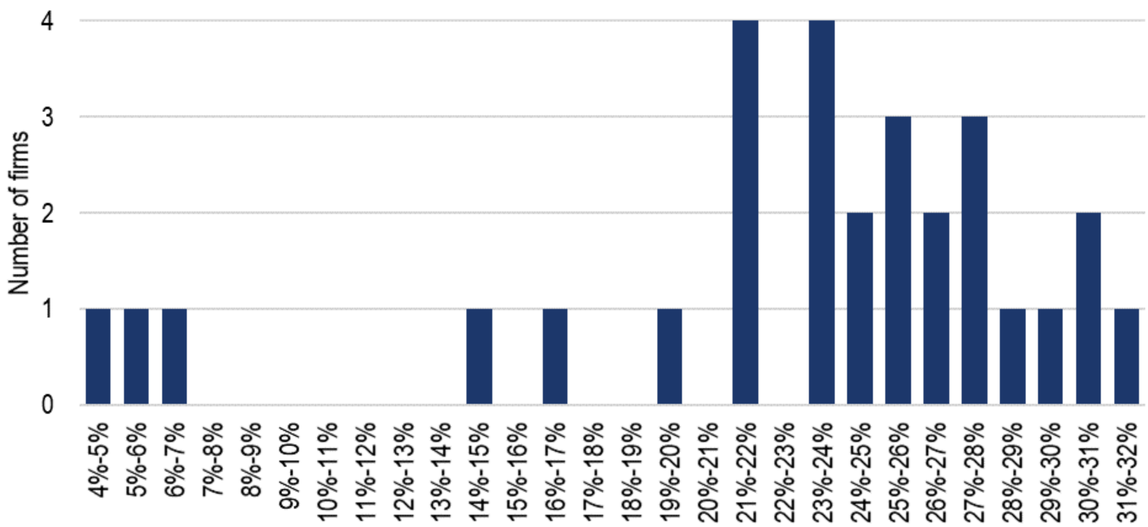
Figure 6 – Gross Profit Margin, 2000 to 2019




*Source: Bloomberg and Incenta analysis*

131. The figure also shows the effect of removing the UK firms from the sample. When we further investigated the distribution of gross profit margins of the Commission's sample we found that three firms had margins that were materially lower than the rest, being the UK firms in the sample, whose average gross profit margins were all below 8 per cent. This is shown in Figure 7.

Figure 7 – Gross Profit Margin – average for each international grocery retailer, 2010 to 2019




*Source: Bloomberg and Incenta analysis*

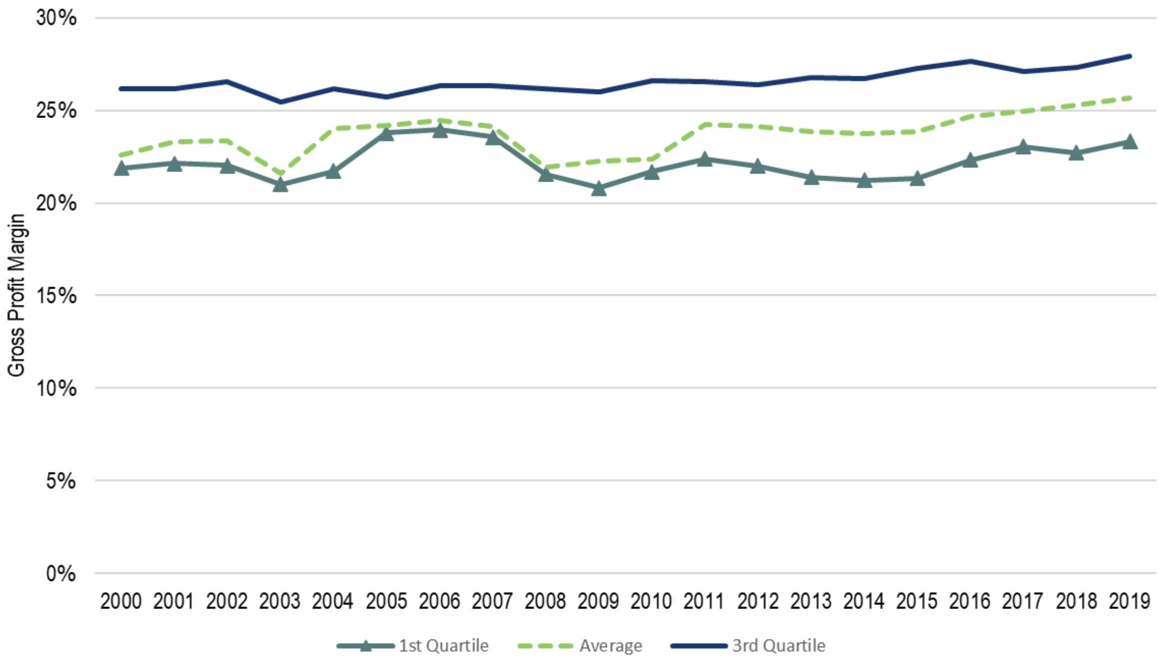
132. When we examined the reporting / cost structure of these firms and compared them with those of firms located elsewhere (the US, Europe and Australia) we discovered material differences in the apparent structure / reporting of costs. Compared to non-UK supermarkets the UK group had a very high COGS / Revenue ratio, but a correspondingly low ratio of non-COGS operating expenses / Revenue. As a result, the total operating costs relative to revenue for UK firms were far more similar to non-UK firms than is suggested by the reported GP margins.[58] This suggests that whilst the fundamental operating cost structures are alike, different reporting conventions are being applied, and more specifically that the UK firms record more of their expenses to COGS than firms elsewhere. As a result, we do not consider it valid to place reliance on the GP margins reported by the UK firms when testing the profitability of the Foodstuffs cooperatives.[59]

133. Figure 8 shows the average GP margin for the international grocery retailers over time with the UK firms removed, which in our view provides the more appropriate comparator for the Foodstuffs cooperatives. The average over the whole of the period is approximately 24 per cent to 25 per cent depending on the period over which the average is taken, which is 2 to 3 percentage points higher that the result with the UK firms included. This figure also illustrates the dispersion in the GP margin across the sample of comparable entities, with the average of the interquartile range extending between approximately 22 per cent and 27 per cent.

58 For example, in 2017 the Total Operating Costs (COGS plus other operating costs) / Revenue ratio of the Kroger (KR US Equity) and Woolworths (WOW AU Equity) was approximately 96 per cent and not far from the 98 per cent observed for Tesco (TSCO LN Equity) and William Morrison (MRW LN Equity), the differences in average GP margins was much larger (approximately 26 per cent and 4.5 per cent respectively). We also examined the firms' latest annual reports, where the non-COGS operating expenses were described as "administrative expenses", which suggests the firms include all store level expenses in their calculation of the cost of goods sold, which is consistent with our earlier observations.

59 Alternatively, it would be necessary to re-state the UK firms' GP margin using the same accounting / reporting methods, but this would likely be time-consuming and subject to error in any case.

Figure 8 – Gross Profit Margin with UK firms removed, 2000 to 2019



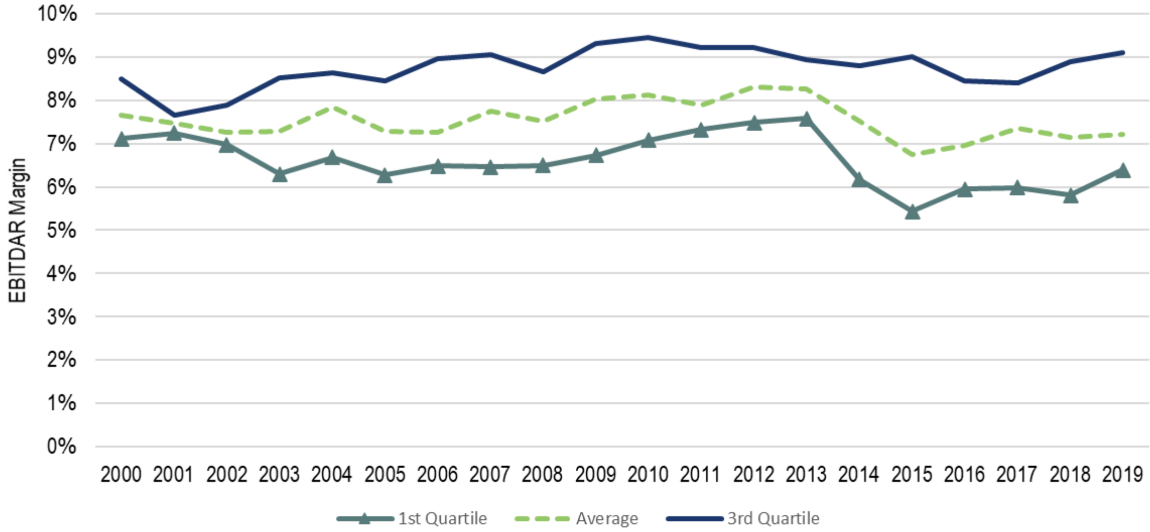

| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| 1st Quartile | 22.2% | 22.1% | 22.5% |
| Average | 23.7% | 24.3% | 24.9% |
| 3rd Quartile | 26.6% | 27.0% | 27.4% |

*Source: Bloomberg and Incenta analysis*

### 3.3.2 Earnings before interest, tax, depreciation, amortisation and rent (EBITDAR)

134. The earnings before interest, tax, depreciation, amortisation and rent (EBITDAR) for the sample of comparable entities is shown in Figure 9.

Figure 9 – EBITDAR margin for the international grocery retailers, 2000 to 2019



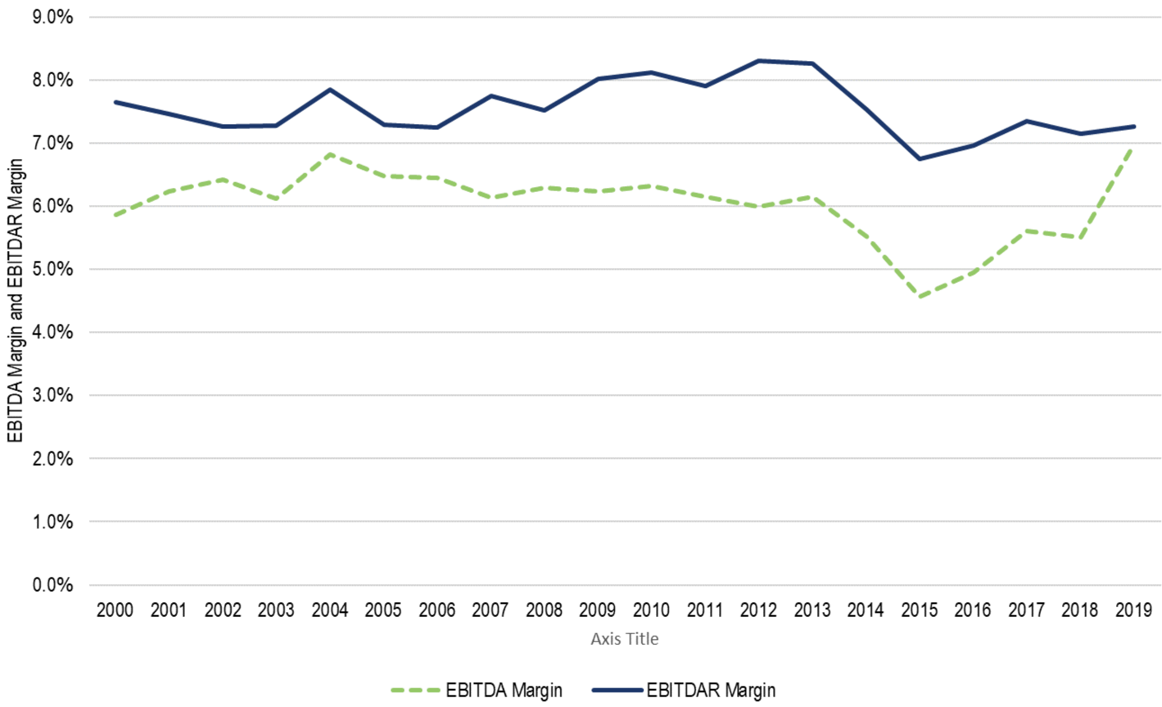

| | 2000-2019 | 2010-2019 | 2015-2019 |
|---|---|---|---|
| 1st Quartile - Average | 6.6% | 6.5% | 5.9% |
| Average | 7.5% | 7.6% | 7.1% |
| 3rd Quartile - Average | 8.8% | 9.0% | 8.8% |

*Source: Bloomberg and Incenta analysis*

135. This shows an average EBITDAR margin of between 7 per cent and 7.5 per cent over time, depending on the averaging period. However, it also shows that there is a material dispersion in the margins achieved for individual firms, with the average of the interquartile range spanning approximately 6 per cent to 9 per cent.

136. Figure 10 shows for completeness the difference between the EBITDAR margin as reported above, and the EBITDA margin, for the international grocery retailers. As our discussion in section 2.2.2 predicted, the EBITDA margin is materially below the EBITDAR margin over most of the period, which reflects the distorting effect of the treatment of rent under the previous accounting standards. The fact that the gap had almost closed in the final year of the period reflects the fact that many companies had implemented the new lease accounting standards by this time (with a complete coverage in the following year, 2020).

**Figure 10 – EBITDAR Margin vs EBITDA Margin, 2000 to 2019**




*Source: Bloomberg and Incenta analysis*

## 3.4 Comparing Foodstuffs profitability to the international grocery retailers

137. Table 8 summarises our estimates of the profitability results for the international grocery retailers that we presented earlier, and shows the corresponding performance of the Foodstuffs cooperatives that we have been provided. The figures for the Foodstuffs cooperatives reflect our advice on how profitability should be measured that were set out in chapter 2, and so reflect:[60]

a. returns calculated across the whole of the cooperatives (i.e., "whole of business" bases)

b. an assumption of asset ownership (being the actual case for the cooperatives)

c. cash included in capital employed (we confirmed that the whole-of-business cash balances of the cooperatives were close to our benchmark, with one slightly above and one slightly below)

60 The returns for the Foodstuffs cooperatives that are reported in this section include sites that have been purchased for future development (at historical cost) in capital employed. In our view, retaining these assets in capital employed is required to provide a fair comparison against the international grocery retailers, which – being owners of the majority of their assets – are likely also to have similar assets in their capital employed. However, we note that if these assets were removed for the Foodstuffs cooperatives, then ROACE would increase to 9.7 per cent and 12.2 per cent for FSNI and FSSI respectively, which would not lead us to alter our conclusions.

d. with assets valued at current market value (albeit with no allowance made for the unbooked intangible assets), and

e. averaged over the longest period for which reliable returns across the whole of the cooperatives reliably can be calculated (5 years for each of the cooperatives).

138. In section 2.3, we observed that for there to be any validity to inferences drawn about competition from a measurement of profitability, a sufficient time period is required in order to reflect a period during which the effect of macro-economic factors and competition responses (including entry and exit) would have the opportunity to work through. There are two issues to consider here.

a. *The period over which the profitability for the Foodstuffs cooperatives is measured* – it is only practicable for the profitability for the cooperatives to be calculated on a "whole of business" basis for a five-year period (excluding 2020). We have reservations as to whether this is a sufficiently long period to permit any inferences about competition to be drawn, although we proceed below on the assumption that this period is the minimum necessary.

b. *The period over which the profitability for the international grocery retailers is measured* – which we have proposed as the appropriate benchmark for assessing the returns of the cooperatives. We have presented information for this sample that spans a period of 5, 10 or 20 years, and in our view the averages over the longer periods should be preferred on the basis that they are less likely to be affected by transitory events. As a practical matter, however, the choice between averaging periods when deriving the return benchmarks is not particularly material to our analysis.

**Table 8 – Summary of profitability benchmarks and the performance of Foodstuffs**

| | 2000-19 | 2010-19 | 2015-19 |
|---|---|---|---|
| Return on average capital employed | | | |
| First quartile - averaged | 6.2% | 5.8% | 5.2% |
| Average - averaged | 10.5% | 10.2% | 9.2% |
| Third quartile - averaged | 13.2% | 13.4% | 12.6% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **9.2%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **11.5%** | |
| Gross profit margin | | | |
| First quartile - averaged | 22.2% | 22.1% | 22.5% |
| Average - averaged | 23.7% | 24.3% | 24.9% |
| Third quartile - averaged | 26.6% | 27.0% | 27.4% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **22.2%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **22.4%** | |
| Earnings before interest, depreciation, amortisation and rent | | | |
| First quartile - averaged | 6.6% | 6.5% | 5.9% |
| Average - averaged | 7.5% | 7.6% | 7.1% |
| Third quartile - averaged | 8.8% | 9.0% | 8.8% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **8.1%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **7.1%** | |

*Source: Bloomberg, Foodstuffs cooperatives and Incenta analysis*

139. The observations we draw about how the returns of the Foodstuffs cooperatives compare to the international grocery retailers as presented in Table 8 are as follows:

a. *ROACE* – the average ROACE for the FSNI cooperative is very close to, or slightly below, the average ROACE of the international grocery retailers (slightly below when the benchmark return is measured over the longer periods). The average ROACE for the FSSI cooperative is above the average of the international grocery retailers, but within the interquartile range for those retailers. As discussed above, the interquartile range shows the ROACE that is consistent with the experience of the central half of international retailers, with a quarter having returns below this and a quarter above.

b. *Gross profit margin* – the average gross profit margin for both of the cooperatives (which are very similar) are below the average of the group of international grocery retailers, and close to the lower end of the interquartile range.

c. *EBITDAR margin* – in relation to this indicator, the positions for ROACE are reversed, with the FSNI cooperative's EBITDAR margin sitting slightly above the average for the international grocery retailers but within the interquartile range, whereas the margin for FSSI is slightly below the average observed for the international grocery retailers (but again within the interquartile range).

140. In our view, the margins observed for the Foodstuffs cooperatives do not provide evidence that competition is ineffective. As discussed in section 2.3, a pre-requisite for making such a finding is that the gap between the observed returns and the benchmark of

normal returns is “unequivocally substantial” or “significant”; however, in our view, the evidence does not support this finding. Rather, we note that:

a. on a number of profitability measures, the outcomes for the cooperatives are very close to the average of the international grocery retailers (FSNI ROACE and FSSI EBITDAR)

b. on one measure (gross profit margin), a lower level of profitability is indicated for the cooperatives than for the international grocery retailers, and

c. in all cases, the cooperative’s profitability indicators are within the range of experience of the majority of the international grocery retailers, namely sitting within the interquartile range.

141. Thus, we conclude that our assessment of the profitability of the Foodstuffs cooperatives under our base case assumptions does not support an inference that competition is not working effectively for the benefit of consumers.

142. In the previous sections we also indicated that we would subject our base-case estimates to sensitivities reflecting:

a. the treatment of cash, with the sensitivity showing the effect of removing cash from the definition of capital employed, and

b. the implicit rental interest rate (which is used to adjust the headline ROACEs to obtain a benchmark that is consistent with a firm that owns its assets), with the sensitivity showing the effect of a 2 percentage point increase in the assumed implicit rental interest rate.

143. Table 9 sets out these results. We draw the following from these results:

a. *Cash balances* – ROACE for FSNI remains close to the average of the sample of international grocery retailers and the ROACE for FSSI remains comfortably within the interquartile range, and

b. *Implicit rental interest rate* – ROACE for FSNI is now below the average of the international grocery retailers, and the ROACE for both cooperatives remains within the interquartile range.

Table 9 – Sensitivities for ROACE

| | 2000-19 | 2010-19 | 2015-19 |
|---|---|---|---|
| Cash removed from capital employed | | | |
| First quartile - averaged | 6.5% | 6.1% | 5.5% |
| Average - averaged | 11.1% | 10.8% | 9.6% |
| Third quartile - averaged | 13.2% | 13.4% | 12.9% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **9.8%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **12.1%** | |
| Implicit lease interest cost +2% | | | |
| First quartile - averaged | 7.0% | 6.5% | 5.8% |
| Average - averaged | 11.6% | 11.3% | 10.1% |
| Third quartile - averaged | 13.7% | 13.9% | 13.3% |
| FSNI Cooperative (Whole-of-Business) (2015-19) | | **9.2%** | |
| FSSI Cooperative (Whole-of-Business) (2015-19) | | **11.5%** | |

*Source: Bloomberg, Foodstuffs cooperatives and Incenta analysis*

144. Accordingly, these sensitivities do not give cause to review the conclusions reached above, namely that our assessment of the profitability for the Foodstuffs cooperatives does not support an inference that competition is not working effectively for the benefit of consumers.

# A. Relationship between ROACE and renting (hidden leverage)

145. Assume the following notation:

$\gamma$ = proportion of the total assets employed that are owned with (1 - $\gamma$) being the proportion that are rented

$\alpha$ = implicit rental interest rate

$A$ = total assets employed (whether owned or leased)

*Rev* = total revenue

*Opex* = operating expenses

*Dep* = depreciation

*r* =return (ROACE) for a 100 per cent owner of assets

*R* = return (ROACE) for a firm that rents a proportion equal to (1 – $\gamma$) of the total assets employed.

146. The following expressions can be derived for ROACE for a 100 per cent owner of the assets, and for a firm that partly owns and partly rents its assets (ignoring tax for simplicity):[61]

$$r = \frac{Rev - Opex - Dep}{A}$$

and

$$R = \frac{Rev - Opex - \gamma.Dep - (1-\gamma).A.\alpha - (1-\gamma).Dep}{\gamma.A}$$

147. It can be shown that, by combining these expressions and simplifying:[62]

$$R = r + \left(\frac{1-\gamma}{\gamma}\right)(r - \alpha)$$

$$r = R.\gamma + (1-\gamma).\alpha$$

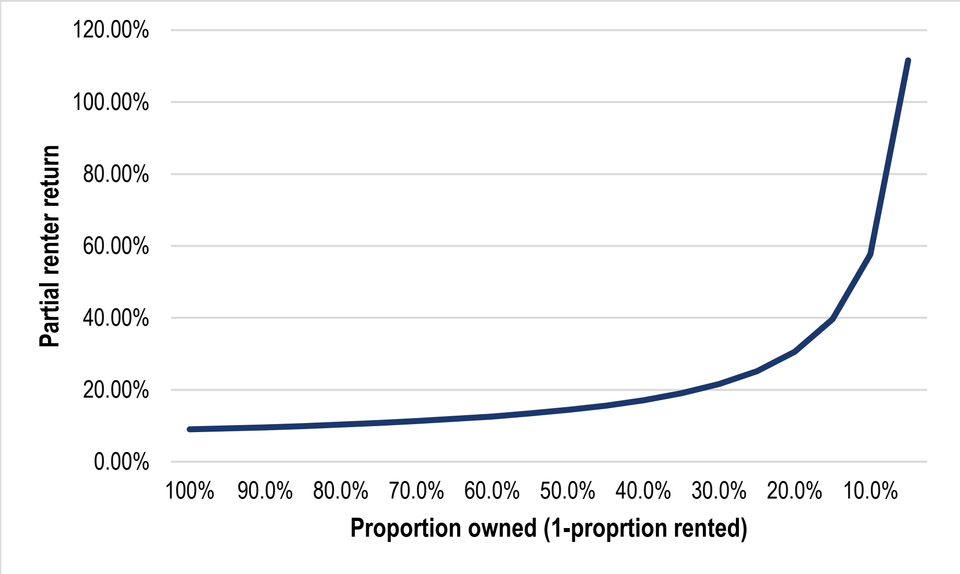
61 The expression for *R* assumes that the rental stream is broken down into an implicit interest component and an implicit depreciation component, which is a requirement of applying IFRS 16.

62 In addition, it is clear that, as all returns are being defined on a post-tax basis, the relevant implicit lease interest rate also needs to be defined on a post-tax basis (i.e., [1-28%] x the “headline” interest rate).

148. The first of these formulae – which relates the (levered) renter return to a purely unlevered return and the implicit rental interest rate – is essentially the same as "equation 8" that was derived by Modigliani and Miller in their seminal work on the effect of financial leverage.[63]

149. Assuming an "owner ROACE" of 9 per cent and a pre-tax implicit rental interest rate of 5 per cent (i.e., post tax interest rate of 3.6 per cent), the return for a renter will be as follows as the proportion of rented assets increases:

**Figure 11 – Variation in return with degree of asset renting**

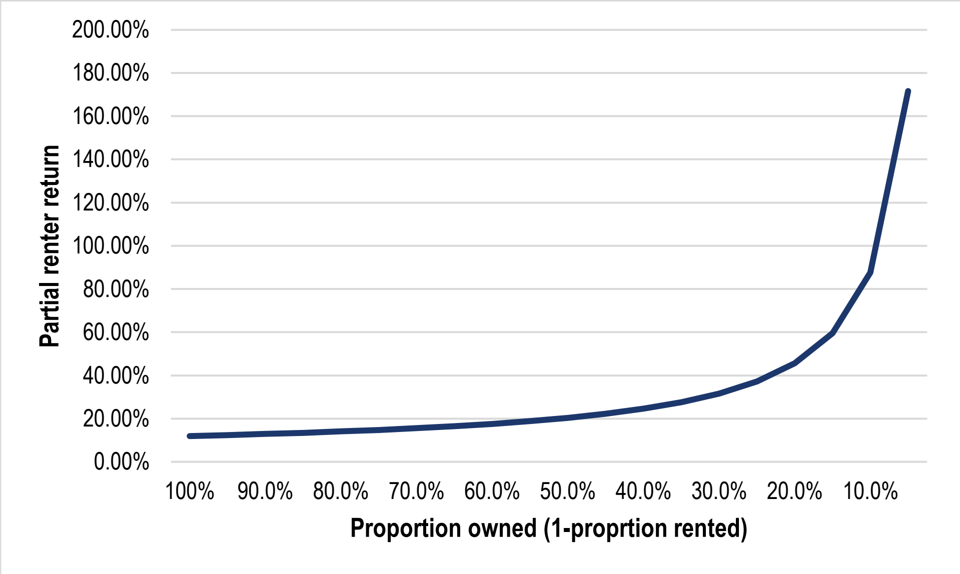



150. Thus, a firm that rents 70 per cent of its assets (which is approximately what the Commission has assumed for the Foodstuffs stores) will have a (required) return of 21.6 per cent.

151. If the owner ROACE is instead 12 per cent, and the implicit pre-tax rental interest rate remains at 5 per cent, then the following is implied:

63 See Modigliani, F., and M. Miller (1958), The Cost of Capital, Corporation Finance and the Theory of Investment, *The American Economic Review*, Vol. 48, No. 3., June, pp. 261-297 (at p.271).

**Figure 12 – Variation in expected return with degree of asset renting (2)**




152. A firm that rents 70 per cent of the total assets employed would have a required return of 31.6 per cent.

## B. Operationalising ROACE leverage estimates

153. The assumptions that we made to operationalise the re-leveraging of ROACE to any predetermined level of renting vs ownership over the period from 2000 to 2019 were as follows:

a. R (ROACE) was calculated for 2020 on a pre-IFRS 16 basis

b. γ (proportion of ownership of assets) is the 2020 Right to Use Assets / Capital Employed pre-IFRS 16 + 2020 Right to Use Assets

c. 2020 Right of Use Assets is derived from:

   i. Bloomberg: (BS_TOT_OP_AND_FIN_LEA_RT_USE_AST), or

   ii. Annual reports for the 2020 financial year if not available in Bloomberg

d. The proportion of ownership (relative to leasing) calculated for 2020 is assumed to apply from 2000 to 2020

e. α before applying the tax adjustment (implicit interest rate in rental agreements) is assumed to be equivalent to the yield on the relevant country's (or Euro Zone) 10 year corporate BBB bonds (annualised) at year end

f. The (annualised) 10-year BBB corporate bond yield is obtained directly for:

   i. US

   ii. UK

   iii. Canada

   iv. Australia

   v. Euro Zone (EU countries using the Euro)

g. For comparators located in Poland, Turkey and Israel:

   i. The 10-year Government Bond Rate in each country + Debt Margin over the 10-year Euro Government bond rate (annualised)

h. For the comparator located in Mexico:

   i. The 10-year Mexico Government Bond Rate + Debt Margin over 10-year US Government Bond Rate (both annualised)

i. The Corporate Statutory Tax Rate for each country for each year between 2000 and 2020 is drawn from Bloomberg (e.g. KPMGUS Index for the US etc.)

j. The implicit interest rate is calculated as a 10-year Trailing Average commencing in 2009, with bond rates assumed to be constant prior to 2009.

## C. ROACEs for the NZX50 Index by firm and industry sector

### Table 10 – ROACEs for the NZX50 Index by firm and industry sector, 2015 to 2019

| Industry sector | Company name | Weights (Capital Employed) | Weights Enterprise Value | Simple ROACE | Weighted Average ROACE Capital Employed | Weighted Average ROACE Enterprise Value |
|---|---|---|---|---|---|---|
| Consumer Discretionary Products | Kathmandu Holdings Ltd | 0.3% | 0.4% | 14.2% | | |
| | SKYCITY Entertainment Group Ltd | 2.0% | 2.4% | 8.8% | | |
| | Restaurant Brands New Zealand Ltd | 0.1% | 0.5% | 17.8% | | |
| | Consumer Discretionary Products | 2.5% | 3.3% | 13.6% | 10.0% | 10.9% |
| Consumer Staple Products | Fonterra Co-operative Group Ltd | 12.2% | 11.4% | 4.7% | | |
| | a2 Milk Co Ltd/The | 0.3% | 2.4% | 43.7% | | |
| | Scales Corp Ltd | 0.3% | 0.4% | 19.2% | | |
| | Sanford Ltd/NZ | 0.7% | 0.6% | 5.6% | | |
| | Consumer Staple Products | 13.4% | 14.8% | 18.3% | 5.8% | 11.4% |
| Financial Services | NZX Ltd | 0.1% | 0.2% | 23.2% | | |
| | Tourism Holdings Ltd | 0.3% | 0.4% | 10.6% | | |
| | Financial Services | 0.4% | 0.6% | 16.9% | 12.8% | 15.1% |
| Health Care | Fisher & Paykel Healthcare Corp Ltd | 0.7% | 4.1% | 24.0% | | |
| | Ryman Healthcare Ltd | 4.4% | 4.0% | 7.9% | | |
| | EBOS Group Ltd | 0.8% | 1.9% | 18.6% | | |
| | Health Care | 2.0% | 1.2% | 9.4% | | |
| | Arvida Group Ltd | 0.7% | 0.3% | 5.8% | | |
| | Oceania Healthcare Ltd | 0.5% | 0.2% | 13.2% | | |
| | Pacific Edge Ltd | 0.0% | 0.2% | -104.8% | | |
| | Health Care | 9.1% | 11.8% | -3.7% | 2.0% | 13.7% |
| Industrial Services | Auckland International Airport Ltd | 6.2% | 7.1% | 7.3% | | |
| | Mainfreight Ltd | 0.8% | 1.7% | 14.6% | | |
| | Port of Tauranga Ltd | 1.2% | 2.4% | 8.7% | | |
| | Air New Zealand Ltd | 4.9% | 3.1% | 9.2% | | |
| | Freightways Ltd | 0.3% | 0.9% | 25.1% | | |
| | Napier Port Holdings Ltd | 0.0% | 0.0% | 3.9% | | |
| | Industrial Services | 13.4% | 15.3% | 11.5% | 8.9% | 9.8% |
| Media | Pushpay Holdings Ltd | 0.0% | 0.3% | -146.1% | | |
| | Serko Ltd | 0.0% | 0.1% | -74.0% | | |
| | SKY Network Television Ltd | 0.3% | 1.6% | -44.5% | | |
| | Media | 0.3% | 1.9% | -88.2% | -50.5% | -60.1% |
| Real Estate | Goodman Property Trust | 2.4% | 1.8% | 10.3% | | |
| | Precinct Properties New Zealand Ltd | 2.1% | 1.5% | 8.9% | | |
| | Kiwi Property Group Ltd | 2.8% | 2.0% | 7.0% | | |
| | Vital Healthcare Property Trust | 1.2% | 0.9% | 12.8% | | |
| | Property for Industry Ltd | 1.2% | 0.9% | 9.9% | | |
| | Argosy Property Ltd | 1.5% | 1.1% | 8.0% | | |
| | Stride Property Group | 1.0% | 0.8% | 8.9% | | |
| | Investore Property Ltd | 0.3% | 0.2% | 8.3% | | |
| | Real Estate | 12.5% | 9.1% | 9.3% | 9.1% | 9.1% |
| Utilities | Spark New Zealand Ltd | 2.6% | 5.4% | 15.3% | | |
| | Chorus Ltd | 4.1% | 2.5% | 4.8% | | |
| | Meridian Energy Ltd | 8.3% | 6.0% | 3.6% | | |
| | Mercury NZ Ltd | 5.9% | 4.1% | 4.6% | | |
| | Infratil Ltd | 6.5% | 4.0% | 2.9% | | |
| | Contact Energy Ltd | 5.0% | 4.2% | 4.3% | | |
| | Vector Ltd | 4.1% | 4.3% | 6.9% | | |
| | Genesis Energy Ltd | 3.6% | 2.4% | 4.2% | | |
| | Trustpower Ltd | 1.5% | 0.8% | 6.4% | | |
| | Utilities | 41.6% | 33.8% | 5.9% | 5.0% | 6.2% |
| Other | Skellerup Holdings Ltd | 0.2% | 0.3% | 16.5% | | |
| | Synlait Milk Ltd | 0.5% | 0.8% | 10.8% | | |
| | Vista Group International Ltd | 0.1% | 0.4% | 22.1% | | |
| | Z Energy Ltd | 1.4% | 2.3% | 11.0% | | |
| | Fletcher Building Ltd | 4.7% | 5.5% | 5.3% | | |
| | Other | 6.9% | 9.2% | 13.2% | 7.4% | 8.2% |
| Grand Average / Sum | | 100.0% | 100.0% | 2.4% | 6.8% | 7.8% |

*Source: NZCC, Bloomberg and Incenta analysis. The weighted average ROACE using capital employed as weights is our reconstruction of the Commission's figures, which is materially the same as the results the Commission presented (the average reported here for 2015-19 of 6.8 per cent compares to the Commission's corresponding estimate of 6.9 per cent).*

# Empirical evidence of grocery sector competition

A report for Foodstuffs

9 September 2021

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## Disclaimer

# Contents

# Figures

# Executive summary

1. We have been asked by Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI) to prepare a report in response to the market study into the retail grocery sector being undertaken by the Commerce Commission (the Commission).

2. The essence of the Commission's preliminary findings is that the major grocery retailers amount to a duopoly and choose strategies that limit the extent to which they compete directly with each other.[1] In light of that finding, the Commission's preliminary view is that competition is 'not effective' in the retail grocery sector.

3. These findings rely on five forms of empirical evidence as to the nature and intensity of competition in the retail grocery sector.[2] The purpose of this report is to examine the Commission's interpretation of three of those forms of empirical evidence and to assess the reasonableness of its preliminary findings in light of that evidence. Specifically, we examine the evidence available to the Commission in relation to:

   a. the nature of competition in the retail grocery sector;

   b. the major grocery retailers' pricing behaviour and promotions; and

   c. the price effects of variations in the degree of local market competition.

## Nature of competition

4. The Commission undertook an analysis of the nature of competition to assess both the dimensions upon which competition is occurring in the retail grocery market and the intensity of competition between different types of grocery retailers.[3] In particular, the Commission drew on a qualitative study undertaken by Ipsos and its own survey of consumers to examine consumer shopping behaviour and to identify the types of grocery retailers that compete with each other.

5. Referencing this evidence, the Commission's principal conclusion as to the nature of competition is that many consumers prefer to buy their groceries at a 'one-stop shop'.[4] Specifically, the Commission states that most consumers undertake a main shop, with this typically occurring at a major grocery retailer, on the basis that convenience and price are key drivers of store choice, ie:[5]

> Our preliminary finding is that a significant proportion of consumers prefer to buy groceries during a main shop in one of the major grocery retailers' stores.
>
> While consumers choose where to shop based on a range of factors which can vary by type of shopping mission, convenience and price are key drivers of store choice, and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location…This means that other grocery retailers who have a more limited or targeted range of products and fewer stores are not a serious competitive constraint on the major grocery retailers.

6. By contrast, we explain in section 2 that the Commission's survey findings and the Ipsos study do not offer any support for its classification of a main shop and that, by focusing on a main shop, the

[1] See paragraph 21 below.

[2] See paragraph 22 below.

[3] See paragraph 27 below.

[4] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[5] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

Commission's competition analysis neither captures the majority of shopping trips nor accounts for the competitive effect of other grocery retailers.

## Pricing behaviour and promotions

7. The Commission analysed both price changes and promotions in the local grocery market to determine whether there is effective retail competition, with the results of this analysis presented in attachment E of its draft report.[6] In particular, the Commission examined:

   a. the scope, timing and quantum of promotions to assess the extent to which retailers may be accommodating each other by coordinating promotions; and

   b. the extent of the price response to changes in costs to assess the extent to which cost savings are passed on to consumers, ie, pass-through analysis.

8. The Commission found that there is some evidence that grocery retailers pass through cost increases more readily than cost decreases and avoid promoting items at the same time, ie:

> There is limited evidence of retailers passing through cost reductions to consumers. As discussed in Attachment E, analysis we have undertaken indicates that most retailers have a substantial proportion of products with estimated pass-through rates significantly less than 100%.[7]
>
> We have also seen some evidence that promotional clashes are avoided for some products…[8]

9. In contrast to the intimations drawn by the Commission, we explain in section 3 that the Commission's analysis in relation to promotions and price changes are consistent with dynamic, competitive interactions between the two major grocery retailers. The Commission's analysis shows that price promotions were common, substantial and varied in their form, indicating that there is strong competition between grocery retailers.

10. Moreover, the Commission found no pattern of high correlations between weekly average prices for products within geographic clusters, indicating dynamic competition between the major grocery retailers and an absence of coordination.

11. Similarly, the Commission's pass-through analysis suggests that competition is dynamic, with a substantially higher rate of pass through of cost changes that affect both the major grocery retailers, as compared with those that affect just one of them.

## Competition in the local grocery markets

12. The Commission draws on analysis undertaken by Frontier Economics to examine the extent to which the structure of local grocery markets affects price competition between stores.[9] Specifically, Frontier Economics undertook an analysis of:

    a. the levels of local market concentration in the areas surrounding 694 major grocery stores to assess how variations in concentration across local grocery markets are related to variations in prices; and

    b. a sample of 32 events when stores entered, exited, changed location or rebranded to assess whether these events had an economically significant effect on the prices charged by competing stores within the same local markets.

[6] See paragraph 118 below.

[7] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 287, paras 8.137-8.138.

[8] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 141, para 5.152.

[9] See paragraph 151 below.

13. The Commission states that Frontier Economics' analysis suggests that local market concentration has a limited effect on price competition, and concludes that such a finding suggests that competition between major grocery retailers is not effective, ie:[10]

> Overall, the analysis by Frontier Economics suggest that local market concentration appears to have little or no effect on price competition between the major grocery retailers. This is consistent with our preliminary finding that price competition between the major grocery retailers is less than we would expect in a workably competitive market.

14. In relation to Frontier Economics' event or entry and exit analysis, the Commission concludes that the entry or exit of major grocery retailers has a limited effect on the prices charged by close competitor stores, ie:[11]

> Frontier Economics found that there was no systematic relationship between the entry, exit or rebranding of a store and the prices charged by close competitor store in the 12 months after the event. This is consistent with their finding that local market concentration levels appear to have little or no effect on price competition between most of the major grocery retailer banners.

15. The Commission then extends its conclusions from these analyses to support its view that other grocery retailers do not constrain the prices of major grocery retailers at the local, regional or national level, ie:[12]

> The finding that local market concentration appears to have little or no effect on price competition between grocery retailers also appears to confirm that the aggregated effect of competition by other grocery retailers in local markets is not sufficient to increase the intensity of competition at either a local, regional or national level…
>
> The lack of evidence that entry by two new Farro Fresh stores in Auckland constrained the pricing of the major grocery retailers in close proximity to these new openings seems to support the view that that there is little evidence that other grocery retailers have an effect on the prices set by the major grocery retailers…

16. We explain in section 4 that the analysis undertaken by Frontier Economics is not consistent with the Commission's view that competition is not effective in the retail grocery sector because:

   a. the conclusion drawn from Frontier Economics' analysis that local market concentration appears to have little or no effect on prices *at the local level* is completely consistent with competition in the retail grocery sector being effective *at the national level*; and

   b. the conclusion drawn from Frontier Economics' analysis that there is no systematic relationship between the entry, exit or rebranding of a store and the prices charged by a *local competitor store* is also completely consistent with competition in the retail grocery sector being effective at *the national level*.

## Conclusion

17. Our detailed examination of three of the forms of empirical evidence relied upon by the Commission shows that none of the evidence is consistent with its preliminary finding that competition is not effective in the retail grocery sector.[13] In particular, the empirical evidence as to:

   a. the nature of competition, as revealed in the data underpinning the Commission's own survey and a qualitative study undertaken by Ipsos, offers no support for either the Commission's classification of and emphasis on a 'main shop' or its related contention that, with their more

[10] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.125.

[11] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 137-138, paras 5.131.

[12] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 136-138, paras 5.126-5.132.

[13] See section 5.

limited or targeted range of products, other grocery retailers 'are not a serious competitive constraint on the major grocery retailers';[14]

b. the nature and extent of promotions is not consistent with any systematic accommodating conduct, while the major grocery retailers' price responses to cost changes provide no tangible evidence of a 'slightly stronger tendency' to pass through cost increases than cost decreases;[15] and

c. the absence of any finding that local market concentration and/or entry and exit events affect local price competition does not imply that the aggregated effect of other grocery retailers is 'not sufficient to increase the intensity of competition at either a local, regional or national level'.[16]

18. Rather, in our opinion the available empirical evidence as to the nature of competition, the extent of promotions, the pass through of cost changes and the primarily national basis on which price competition takes place is all either consistent with or positively supports a conclusion that competition in the retail grocery sector is effective.

[14] See paragraph 28; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[15] See paragraph 137; and Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 431, para E46.

[16] See paragraph 154; and Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.126.

# 1. Introduction

19. We have been asked to prepare this report by the two Foodstuffs cooperatives, ie, Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI). The context for our report is the market study into the retail grocery sector being undertaken by the Commerce Commission (the Commission).

20. The Commission was required under section 51(1) of the Commerce Act 1986 to undertake a study into any factors that may affect competition for the supply or acquisition of groceries by retailers in New Zealand,[17] and has set out its preliminary findings in a draft report released on 29 July 2021.[18]

21. The essence of the Commission's preliminary finding is that the major grocery retailers amount to a duopoly and choose strategies that limit the extent to which they compete directly with each other.[19] In light of that finding, the Commission's preliminary view is that competition is 'not effective' in the retail grocery sector,[20] ie:[21]

> Our preliminary finding is that while there are a number of different retailers operating, the sector is dominated by the major grocery retailers and they appear to be each other's closest competitors. We have seen no evidence to suggest that other grocery retailers constrain the major grocery retailers to a significant extent for a consumer's main shop in any local market(s), either individually or together.
>
> In competition terms, we refer to this as a duopoly with a fringe of other competitors. We have found that the major grocery retailers choose strategies that limit the extent to which their retail banners compete directly with each other, particularly on price. For example, we have seen evidence that the major grocery retailers actively monitor one another's price levels for specific products with the aim of managing specified pricing differences between their retail banners.

22. These findings rely on five forms of empirical evidence as to the nature and intensity of competition in the retail grocery sector, ie:

    a. an analysis of the major grocery retailers' profitability in which the Commission's examines whether they earn profits that are above that which would be expected in a workably competitive market;[22]

    b. an analysis of data drawn from a consumer survey undertaken by the Commission and a qualitative study performed by Ipsos as to the nature of competition in the retail grocery sector;[23]

    c. an analysis by the Commission of the major grocery retailers' prices and costs that examines:[24]

        i. the nature and extent of promotions; and

        ii. the extent to which cost changes are passed through into price changes;

[17] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 7, para 1.2.

[18] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021.

[19] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 299, paras 9.10 and 9.12.

[20] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 298, para 9.8; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 3.

[21] Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

[22] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 37-51, paras 3.7-3.64.

[23] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, chapter 4.

[24] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, attachment E.

d. an analysis by Frontier Economics of the price effects of variations in the degree of local market competition, as indicated by:[25]

   i. differing levels of local market concentration; and

   ii. store opening and closing events; and

e. a comparison undertaken by the Commission of the price of groceries in New Zealand and the price of groceries internationally.[26]

## 1.1 Scope of our report

23. In this report, we examine the Commission's interpretation of the available empirical evidence and assess the reasonableness of its preliminary findings in light of that evidence. Specifically, we examine the evidence available to the Commission under items (b), (c)) and (d) above, ie, the nature of competition in the retail grocery sector, the major grocery retailers' prices and costs, and the price effects of variations in the degree of local market competition.

24. Our review finds that none of three of the forms of empirical evidence cited by the Commission is consistent with its preliminary finding that competition is not effective in the retail grocery sector. By contrast, the available evidence is all either consistent with or positively supports a conclusion that competition in the retail grocery sector is effective.

25. In a separate report,[27] we examine the Commission's international price comparisons analysis (being item (e) of the empirical evidence on which the Commission relies), while the Commission's profitability analysis (being item (a) of the evidence for the Commission's preliminary finding) is assessed in a report prepared by Incenta.[28]

## 1.2 Structure of the report

26. We have structured this report as follows:

a. in section 2, we review the Commission's preliminary findings in relation to the nature of competition in the retail grocery sector and explain that its own empirical evidence is not consistent with its preliminary findings;

b. in section 3, we assess the Commission's analysis of the price and cost dynamics of the major grocery retailers, and explain that this analysis is not consistent with the Commission's preliminary findings; and

c. in section 4, we examine the Commission's preliminary findings in relation to Frontier Economics' analysis of the price effects of variations in the degree of local market competition and explain that the Commission's findings are not consistent with the results of Frontier Economics' analysis.

[25] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 135-138, paras 5.116-5.132.

[26] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 51-66, paras 3.65-3.130.

[27] HoustonKemp, *International comparisons of grocery prices*, 9 September 2021.

[28] Incenta, *Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability*, September 2021.

# 2. Nature of competition

27. The Commission undertook an analysis of the nature of competition to assess both the dimensions upon which competition is occurring in the retail grocery market and the intensity of competition between different types of grocery retailers.[29] In particular, the Commission drew on a qualitative study undertaken by Ipsos and its own survey of consumers to examine consumer shopping behaviour and to identify the types of grocery retailers that compete with each other.[30]

28. Referencing this evidence, the Commission's principal conclusion as to the nature of competition is that many consumers prefer to buy their groceries at a 'one-stop shop'.[31] Specifically, the Commission states that most consumers undertake a main shop, with this typically occurring at a major grocery retailer, on the basis that convenience and price are key drivers of store choice, ie:[32]

> Our preliminary finding is that a significant proportion of consumers prefer to buy groceries during a main shop in one of the major grocery retailers' stores.
>
> While consumers choose where to shop based on a range of factors which can vary by type of shopping mission, convenience and price are key drivers of store choice, and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location…This means that other grocery retailers who have a more limited or targeted range of products and fewer stores are not a serious competitive constraint on the major grocery retailers.

29. By contrast, in this section we explain that the Commission's survey findings and the Ipsos study do not offer any support for its classification of a main shop and that, by focusing on a main shop, the Commission's competition analysis neither captures the majority of shopping trips nor accounts for the competitive effect of other grocery retailers.

30. In our assessment below of the Commission's findings, we first examine the Commission's economic reasoning as to the nature of competition in the retail grocery sector and then we assess the empirical basis for the Commission's preliminary findings.

## 2.1 Commission's economic reasoning as to the nature of competition

31. The Commission describes the retail grocery sector as 'diverse', with the sector consisting of a range of retailers including supermarkets, specialist and international food stores, convenience stores, online-only supermarkets and meal kit providers.[33] Supermarkets, including major grocery retailers, provide consumers with a wide range of products in one store.[34] In comparison, other grocery retailers provide a range of grocery offerings and may focus on certain product categories or consumer groups.[35]

32. The Commission explains that grocery retailers differentiate their offering to compete for consumers by combining the set of products and services offered in different ways.[36] Typically, grocery retailers differentiate their retail grocery offering across price, quality, range and service by:[37]

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[29] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 11 and 79, paras 1.19 and 4.8.

[30] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 78 and 80, paras 4.1-4.2.

[31] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[32] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[33] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 2.

[34] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 18, para 2.8.

[35] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 18 and 21, paras 2.8 and 2.23.

[36] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 77 and 87, paras 4.47-4.48.

[37] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 80, para 4.12.

a. charging different prices on products, including promotions;

b. providing different quality of products;

c. supplying a different range of available products; and

d. offering a different quality of service and shopping experience.

33. However, the Commission suggests that grocery retailers differentiate their retail grocery offerings largely on non-price dimensions of the retail grocery offer, such as product range and quality.[38] Further, the Commission contends that the major grocery retailers target different types of consumers, thereby limiting price competition between the major grocery retailers.[39]

34. In relation to consumers, the Commission observes that they have a diverse range of preferences for how and where they shop for groceries.[40] Consumers engage in different types of shopping trips, with the Commission describing a particular type of shopping trip as a 'shopping mission'.[41] The Commission classifies shopping missions into three categories, ie:[42]

a. a main shop typically at weekly intervals, or at another regular interval, based on the convenience of using one grocery store to get all necessities in one place;[43]

b. a secondary shop for specific products, typically at a specialist retailer; and/or

c. a top-up shop for a small number of items, often across a range of other grocery retailers.

35. Consumers decide where to undertake a particular shopping mission based on a range of factors, including price, convenience, location and familiarity.[44] The Commission states that drivers of store choice vary according to the type of shopping mission.[45] For example, the Commission finds that most consumers select the store for their main shop based on convenience and price.[46]

36. The Commission states that most consumers regularly undertake a main shop, with this typically occurring on a weekly basis.[47] In addition, the Commission contends that a large proportion of consumers prefer to buy groceries during a main shop in one store and that the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.[48] On these contentions, the Commission suggests that consumers view the major grocery retailers as each other's closest alternatives for the purposes of doing a main shop.[49]

37. In contrast, the Commission finds that consumers are unlikely to consider other grocery retailers as an alternative to the major grocery retailers when undertaking a main shop.[50] Instead, consumers are

[38] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 88-89, paras 4.49 and 4.57.

[39] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 77; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 4.

[40] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 68, para 3.142; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 3.

[41] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 81, para 4.15.

[42] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 81, para 4.18.

[43] See also Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 6.

[44] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 91, paras 4.65-4.66; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[45] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 82, para 4.19.

[46] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 18, para 2.5.

[47] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, pp 3-4.

[48] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, pp 3-4.

[49] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 77 and 97, para 4.86.

[50] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 78, 82 and 98, paras 4.4, 4.19 and 4.94.

more likely to regard other retailers as an alternative for smaller secondary or top-up shopping missions,[51] ie:[52]

> We consider that the extent to which consumers consider other grocery retailers as alternatives to the major grocery retailers appears largely to depend upon the type of shopping mission a consumer is engaged in. Our consumer research indicates that most consumers buy groceries for their main shop in one location and that they typically prefer to use one of the major grocery retailers for this main shop. Grocery retailers stocking a limited range of products are more likely to be regarded by consumers as an alternative for top-up or other smaller shopping missions.

38. Drawing on these considerations, the Commission concludes that the retail grocery sector can best be described as a duopoly with a fringe of other competitors, stating in particular that:[53]

    a. other grocery retailers are not able to offer the convenience of a main shop at a single location and therefore are unlikely to constrain the major grocery retailers to a significant extent;[54] and

    b. major grocery retailers appear to be each other's closest competitors, with differentiation between the store banners resulting in limited competition.[55]

### 2.1.1 Commission's conclusions on the dimensions of competition

39. Grocery products are far from homogeneous, with grocery retailers providing various grocery options differentiated across price, quality, range and service.[56] The Commission identifies that the range of grocery retailers provides consumers with choice and helps meet diverse consumer preferences.[57] As such, the extent of differentiation between grocery retailers would be expected to be positive for consumers and for competition.

40. However, the Commission focuses on consumers' preferences in relation to price and convenience to suggest that differentiation is negative for the retail grocery sector. In particular, the Commission states that other grocery retailers cannot compete with the major grocery retailers on price or range for a consumer's main shop.[58] Instead, these retailers compete by differentiating on non-price components, with the Commission contending that such differentiation allows retailers to avoid competing on price, ie:[59]

> Instead, it appears these retailers strategically compete for smaller consumer shopping missions by differentiating the non-price components of their retail offers such as stocking different, imported or higher quality products, or creating unique shopping experiences.
>
> Product and service differentiation provide a way for grocery retailers to avoid directly competing on price, while seeking to attract consumers from one another in an effort to attract and retain a more loyal consumer base.
>
> Many consumers told us that lower prices are the most important thing for them. Price competition is an important feature of a workably competitive market.

41. Although the Commission suggests that many consumers value lower prices, we explain in section 2.2 below that the Commission's own survey evidence indicates that consumers value a wide variety of

[51] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[52] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 78, para 4.4.

[53] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 4.

[54] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 112, para 5.4; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 4.

[55] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, pp 4 and 11.

[56] See paragraphs 32-33 above.

[57] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

[58] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

[59] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

factors, with only 30 per cent of consumers citing low prices as a factor in their choice of main store.[60] Consequently, the Commission appears to place undue weight on price as the principal basis by which competition does or should take place.

42. Moreover, the Commission's perspective in relation to diversification of product and service offerings stands in contrast to the conventional economic principle that choice increases consumers' utility, ie, choice is a positive feature of any market.[61] By not accounting for the benefits associated with the diversification between other retailers, the Commission has not properly accounted for competitive effect of other grocery retailers on the major grocery retailers.

### 2.1.2 Commission's disproportionate focus on a 'main shop'

43. The Commission analyses competition in the retail grocery sector by imposing its own, highly segmented perspective of consumers' shopping trips into just three types of 'missions'. Specifically, the Commission states that it drew on the feedback it received in its consumer research[62] to separate consumers' shopping trips into three categories of shopping missions, ie, a main shop, a secondary shop and a top-up shop.[63] By consequence of this particular segmentation, the Commission reaches the conclusion that the major grocery stores are each other's closest competitors, ie:[64]

> Our preliminary finding is that while there are a number of different retailers operating, the sector is dominated by the major grocery retailers and they appear to be each other's closest competitors. We have seen no evidence to suggest that other grocery retailers constrain the major grocery retailers to a significant extent for a consumer's main shop in any local market(s), either individually or together.

44. The Commission's finding that other retailers do not constrain the major grocery retailers is a direct consequence of its decision to analyse competition by reference to a main shop. In particular, by focusing its analysis on competition for a main shop, the Commission finds that typically only major retailers can provide consumers with the convenience of using one grocery store to purchase a large range of groceries. This causes the Commission to conclude that only the major grocery retailers compete for a consumer's main shop and that other grocery retailers provide a limited constraint on these retailers.

45. The Commission's finding suggests that consumers can only purchase certain bundles of goods at major grocery retailers. However, consumers can select from a large range of grocery retailers when deciding where to purchase each grocery item. For example, a consumer can decide whether to purchase vegetables from a major grocery retailer, a greengrocer, a farmers' market, an organic grocer or another retailer.

46. By consequence of these options, competition in the retail sector should be analysed by assessing the extent to which various retailers compete for a proportion of a consumer's basket of goods. Such an analysis would acknowledge that there are multiple retailers that provide various grocery items and that consumers can shop between these retailers to purchase the items that meet their price, quality and other requirements. On this basis, other retailers would provide a competitive constraint to the major grocery retailers, since consumers are able to switch to other retailers for some or perhaps the entire proportion of their typical basket of items if the major grocery retailers were to increase prices, reduce quality, limit their range or lower their service standards.

[60] See section 2.2.2.

[61] Classical consumer theory states that more choice makes consumers better off, although behavioural economics suggests that sometimes too much choice can overwhelm consumers. See Hal R. Varian, *Intermediate Microeconomics: A modern approach*, Eighth Edition, 2010, pp 570, 723 and A26.

[62] This research comprising the Commission's survey and the Ipsos study.

[63] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 81, para 4.18.

[64] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

47. The Ipsos qualitative study supports the concept that consumers typically view other grocery retailers as alternatives for purchasing their groceries. For example, Ipsos noted that some participants often undertook shopping trips that allowed them to take advantage of the perceived quality of one retailer and the pricing of another – for example, some found it difficult to find quality meat and produce in the same location as inexpensive grocery items and would seek those at an alternative store.[65]

48. Further, we explain in section 2.2 below that the Commission's own consumer research is not consistent with its decision to analyse competition by focusing on a main shop. Rather, the Commission's consumer research suggests that consumers typically undertake multiple shopping trips per week and commonly purchase baskets of smaller value. Foodstuffs' own basket data also confirms that the average basket size is relatively small.[66] This evidence suggests that, by focusing on a main shop, the Commission's competition analysis does not capture the majority of shopping trips.

## 2.2 Empirical basis for the Commission's draft findings

49. The Commission seeks to draw on the findings of its own consumer survey and Ipsos' market research to support its economic reasoning in relation to the nature of competition in the retail grocery sector.

50. The Commission conducted an online consumer survey in March 2021.[67] The survey contained 30 multiple choice questions, including questions that asked consumers to identify the stores that they visit during a typical week, the number of times they visit those stores and how much they spend.[68] The survey was available to the public for three weeks, with the Commission receiving 12,269 responses.[69] The Commission notes that the number of responses to each question may be less than the total number of responses, on account of it removing potentially unreliable responses and some respondents not providing a response to certain questions.[70]

51. In contrast, Ipsos undertook qualitative research to provide insights into consumer behaviour and perceptions in relation to the NZ grocery retail sector.[71] Ipsos selected 58 participants, with 50 partaking in focus groups, and eight partaking in 'shop-alongs'[72] and individual interviews.[73] Ipsos used a questionnaire to select the participants, allowing it to select a cross-section of New Zealanders and to obtain data on shopping habits.[74]

52. In the remainder of this section, we review the results from this consumer research that are said to underpin the findings of the Commission described in section 2.1 above, being that:

   a. consumers regularly undertake a main shop;

   b. most consumers buy groceries for their main shop in one location and that they typically prefer to use one of the major grocery retailers for this main shop;

[65] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, pp 8-9.

[66] See section 2.2.1.

[67] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 437, para F3.

[68] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 437, para F8.

[69] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 437, para F3.

[70] For a description of the Commerce Commission's approach to data cleaning, see: Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 450-453, paras F57-F68.

[71] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 3.

[72] A shop-along involved interviewing consumers in their home, travelling with them to their preferred grocery shopping location and then observing them during an 'everyday' shop.

[73] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 4.

[74] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 5.

c. price and convenience are the main drivers of the choice of store for a main shop, with price being relatively more important for consumers doing a larger shop;

d. other retailers have a limited effect on major grocery retailers; and

e. competition between the major grocery retailers is limited.

### 2.2.1 Main shop

53. The Commission relies on its consumer research to support for its focus on a main shop. In particular, the Commission draws on this research:

a. to provide support for its classification of a main shop;

b. to establish that most consumers tend to do at least one large shop each week; and

c. that consumers undertake their main shop at one location and typically at a major retailer.

54. However, the Commission's consumer research neither supports its classification of a main shop nor allows for the Commission's findings in relation to the size and frequency of consumers' shopping trips.

55. Moreover, the results of the survey indicate that consumers typically undertake *multiple* shopping trips per week and commonly purchase smaller baskets by value. Foodstuffs' own basket data also confirms that the average basket size is relatively small. This evidence suggests that, by focusing on a main shop, the Commission's competition analysis does not capture the majority of shopping trips.

56. We discuss consumers' shopping behaviour and the Commission's findings in relation to a main shop below.

#### Classification of main shop

57. Although the Commission defines a 'main shop' as being a regular shopping mission where consumers can purchase all necessities in one place, this does not match with the definition of a main shop used in either the Commission's own survey or the phraseology used in the Ipsos questionnaire. Rather, the Commission's definition of a main shop appears to be derived from Ipsos' observations as to comments made during focus group discussions held with participants in its study.

58. In its survey, the Commission asked consumers to select their main grocery store from a list of retailers. However, main store was defined differently in the Commission's draft report. Specifically, 'main store' was defined as 'the one you spend the most at, or do most of your grocery shopping with'.[75]

59. In contrast, Ipsos' questionnaire asked participants to select the places where they 'mainly' do their grocery shopping.[76] Participants were able to select from multiple retailers to answer this question, with the results indicating that few participants shopped for groceries only at a supermarket and that many shop at retailers other than a major grocery retailer. Ipsos itself states that:[77]

> Very few participants shopped for groceries only at a supermarket; most participants also used a full range of grocery locations including Saturday markets and Asian food stores. In Table 6 [presented as Figure 2.1 below], the breakdown of use of different grocery shop locations is tallied based on the participant's response to the recruitment screener question regarding places they

[75] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 492.

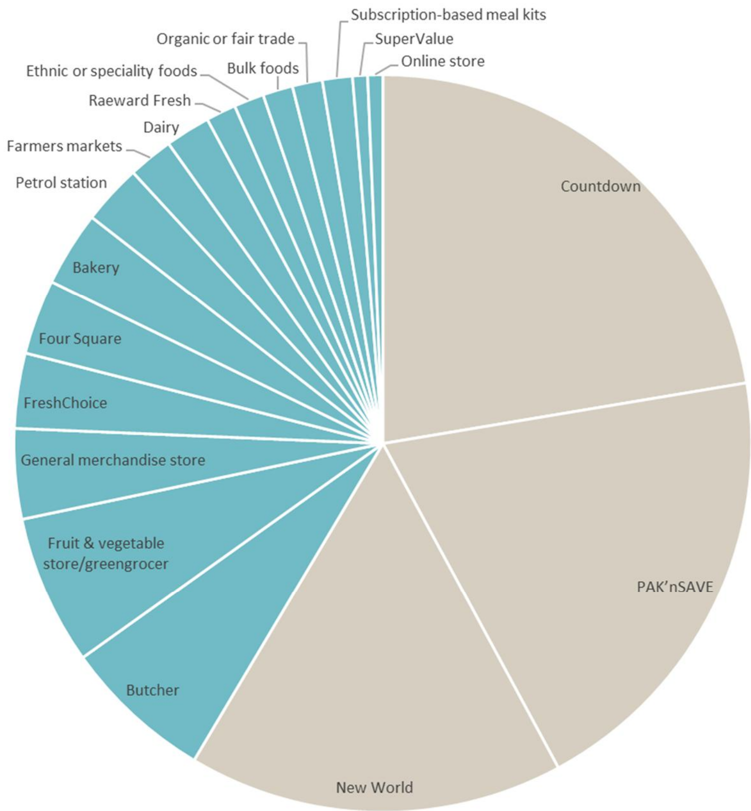
[76] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 64.

[77] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 34.

> mainly do their grocery shopping. Many indicated more than a one-shop type as places they mainly do their grocery shopping.

60. Indeed, Countdown, PAK'nSAVE and New World accounted for only 59 per cent of stores selected by participants in response to Ipsos' question of where they mainly do their grocery shopping, with 41 per cent of selected stores being retailers other than these supermarkets – see Figure 2.1 below.[78]

Figure 2.1: Main grocery shop locations identified by participants to Ipsos study




*Data and sources: HoustonKemp analysis of Ipsos data. See, Ipsos, Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report, July 2021, p 35, table 6.*

61. Notwithstanding the results of its questionnaire indicating that participants regularly shop across a range of retailers, Ipsos states that during the discussions held in the focus groups and individual interviews, participants indicated that they undertake a 'single main shop' at a major supermarket, ie:[79]

> During the discussions and interviews, most participants noted having a single main shop at a major supermarket and visiting these [other] locations to supplement their full grocery order or as a top-up if they ran out of something.

62. However, Ipsos does not provide any explicit support for this statement. Ipsos also does not explain how participants conveyed their preference for a single main shop, ie, whether this was an answer to a leading question posed in discussions and interviews or was pro-offered without prompting. Further,

[78] Calculated from data presented in table 6 of Ipsos' report. See: Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 35, table 6.

[79] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 34.

Ipsos does not describe how many of its 58 survey participants expressed a preference for a single main shop.

63. Ipsos also states that participants discussed that they undertake different forms of shopping missions, including a main shop, a secondary shop and a top-up shop.[80] Specifically Ipsos notes that participants described a main shop as typically happening in the same store each week and being based on the convenience of one location to get all necessities in one place.[81] This summary by Ipsos appears to be the principal underpinning for the Commission's definition of a main shop. However, despite Ipsos' acknowledgement that the distinction between different types of shopping missions being important for understanding participants' shopping behaviours,[82] there is neither any explicit support for this statement nor any explanation of the discussions with survey participants that underpin Ipsos' summary of a main shop.

### Most consumers tend to do at least one large shop each week

64. Although the Commission appears to draw on the commentary derived by reference to Ipsos' focus group discussions to define its concept of a main shop, it also relies on its survey to suggest that most consumers tend to do at least one large shop per week.[83] Specifically, the Commission draws on the response to question four of its survey, which asked consumers to select one of four options that best describe how they usually shop for groceries each week.[84]

65. In response to this question, approximately 37 per cent of respondents selected that they tend to do at least one or two larger shops each week along with a few smaller shops, whereas approximately 35 per cent of respondents selected that they tend to do at least one or two larger shops each week only.[85] Taken together, 72 per cent of respondents indicated that they tend to do at least one or two larger shops each week, with this leading the Commission to conclude that:[86]

> '[m]ost consumers tend to do at least one large shop each week'.

66. The Commission appears to draw on this finding to suggest that most consumers regularly carry out a main shop, ie, the Commission interprets a 'large shop' as a main shop.[87]

67. However, despite the Commission's reliance on the responses to question four of its survey to support its concept of a regular main shop, the framing of this question does not allow for such a conclusion. In particular, the phrasing and use of terms such as 'large' are subjective and would likely have been interpreted differently across respondents. For example, two separate respondents could both select that they undertake one or two large shops (and potentially other smaller shops), but where the first respondent undertakes one large shop of $50 and a number of smaller shops, whereas the other respondent may undertake one large shop of $200.

68. Moreover, the question asked respondents to describe how they usually shop for groceries each week and it is likely that a number of respondents interpreted this question in various ways, ie:

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[80] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, pp 14-15.

[81] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 15.

[82] Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 15.

[83] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 78, paras 4.69-4.73.

[84] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 92-93 and 490, paras 4.69-4.71 and Figure 4.2.

[85] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 93, Figure 4.2.

[86] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 92, paras 4.69-4.71.

[87] The Commission defines a main store as the store in which consumer's spend the most, with the commission interpreting shopping at this store as a main shop. See paragraph 58 above and Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 78, para 4.4.

a. some respondents may have understood such a question about 'groceries' to be about how they shop for items at a supermarket as opposed to other retailers, eg, a butcher; or

b. some respondents may have interpreted this question as the number of combined shopping trips that they undertake per week, ie, some respondents may undertake visit multiple grocery retailers during one outing.

69. The ambiguity of question four is demonstrated by the respondents' answers to later questions in the survey. Specifically, a number of respondents selected that they tend to do at least one or two large shops each week only, but then later identified that they typically shopped at a major grocery retailer as well as various other grocery retailers. For example, one respondent selected that they tend to do at least one or two large shops each week only, but identified that in a typical week that they:[88]

a. visit Countdown twice, spending a total of between $200 and $300 across those trips (ie, an average of $100 to $150 per visit);

b. visit a single-category or specialist grocer once, spending between $50 and $100; and

c. shop with a meal kit provider once, spending between $100 and $200.

70. The ambiguity of this question does not allow for any conclusion on typical shopping behaviour, with the results providing limited insight into the size and frequency of how consumers shop.

71. However, the average size and frequency of consumers' shops can be observed directly via the answers to questions six and seven of the Commission's survey, ie:

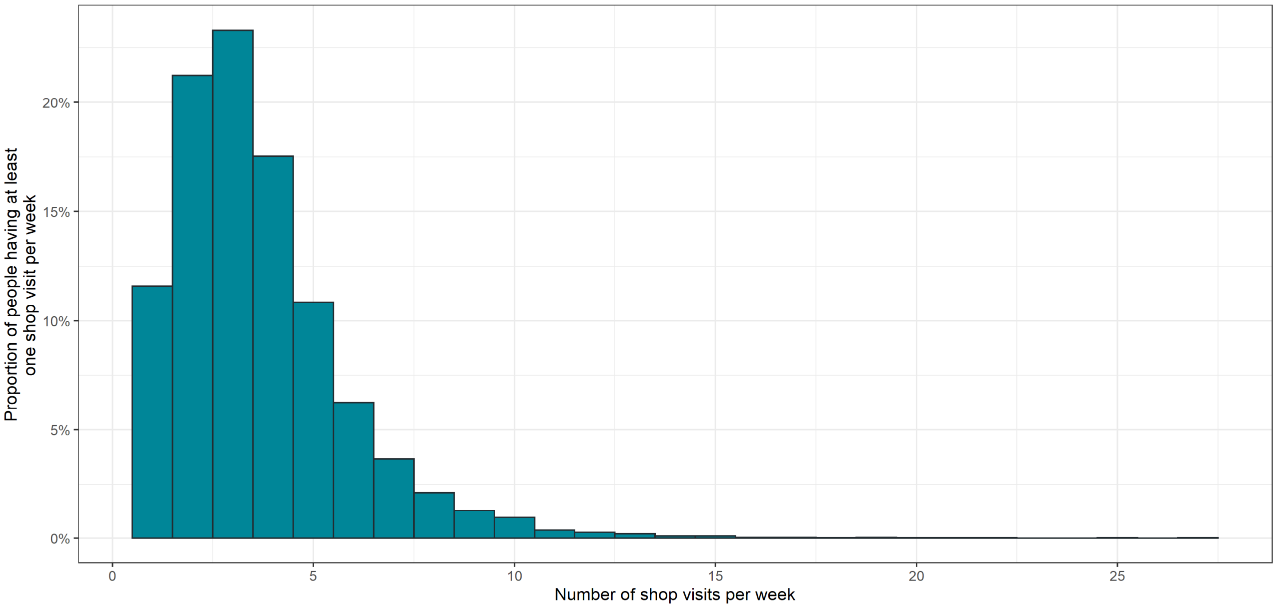
a. question six asked consumers to identify the number of times that they would shop with each store during a typical week – the sum of the visits across each of the stores will therefore result in the number of individual shops (ie, the number of shopping baskets that they purchase) that consumers undertake per week; and

b. question seven asked consumers to identify how much they spend at each store during a typical week – the total spend at each store can be divided by the number of times the respondent visits that store during a typical week to estimate an average spend per individual shop.

72. We present the results of these analyses in figures Figure 2.2 and Figure 2.3 below.

[88] Assetid 239928 from the Commission's cleaned survey data.

Figure 2.2: Number of shop visits in a typical week, according to the Commission's survey




*Notes and sources: HoustonKemp analysis of the Commission's cleaned survey data. The graph reflects the number of store visits that respondents make during a typical week based on their answer to question six, eg, a respondent that indicated that they visit New World twice per week, a green grocer once per week and a specialty store once per week would be counted as undertaking four shop visits.*

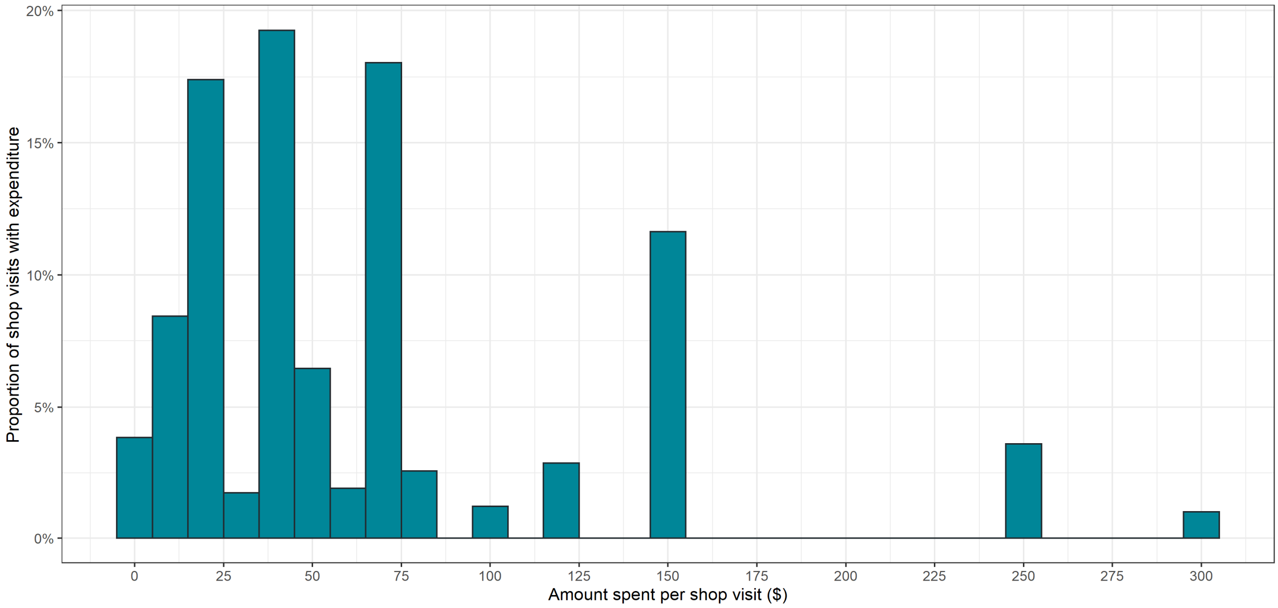
73. Figure 2.2 illustrates that less than 12 per cent of respondents that undertake shopping on a weekly basis undertake only one shop. In contrast, approximately 88 per cent undertake two or more shops[89] and 67 per cent undertake three or more shops,[90] with respondents undertaking an average of 3.7 shops per week.[91] Consequently, the majority of respondents undertake more than one shop per week with a large proportion undertaking at least three shops per week, ie, the majority of respondents purchase at least three shopping baskets each week.

[89] In particular, they purchase two or more separate baskets per week from either a single store or a range of stores.

[90] In particular, they purchase three or more separate baskets per week from either a single store or a range of stores.

[91] HoustonKemp analysis of the Commission's cleaned survey data.

Figure 2.3: Average value of shopping baskets, according to the Commission's survey




*Notes and sources: HoustonKemp analysis of the Commission's cleaned survey data. The graph reflects the respondents' average spend per individual shopping trip (ie, shopping basket) during a typical week based on their answer to question seven. Shopping spends were given on a weekly basis in the form of a range and, as such, we took the mid-point of each range – our approach is in line with the approach taken by the Commission, however it appears that we differ in our mid-point for the $300+ bracket, with the Commission adopting a midpoint of $350 whereas we adopt $300 on the basis that the upper bound is undefined. Where respondents undertake multiple shops at a given store, we divide the total weekly spend by the number of times the respondent visits that store during the week to estimate an average spend per individual shopping trip. We then plot the average value of a shopping basket, with these presented in the above histogram using bins of $10 in width – ie, each bar covers a range of spends within $10.*

74. Figure 2.3 highlights that the majority of shopping trips undertaken by respondents are relatively small, with the average value of respondents shopping baskets being approximately $67.[92] Approximately 57 per cent of the respondents' shopping trips have an average spend of less than or equal to $50 and approximately 81 per cent have an average spend of less than or equal to $100.

75. Moreover, FSNI's own data is consistent with the findings from question seven of the Commission's survey, ie, that consumers undertake more smaller shopping trips as compared with larger shopping trips (by basket value).

76. Figure 2.4 below illustrates the percentage of all shopping trips (baskets) with a basket value within a given range during 2019. The first panel divides all shopping baskets into value ranges of [[redacted]], the second panel into ranges of [[redacted]] and the third panel into value ranges of [[redacted]].

[92] HoustonKemp analysis of the Commission's cleaned survey data.

Figure 2.4: Basket value by Foodstuffs North Island banners during 2019

*Source: Data provided by FSNI and analysed by HoustonKemp.*

77. Figure 2.4 highlights that, for each banner, less than [[redacted]] per cent of baskets exceed [[redacted]] and the majority of baskets are less than [[redacted]] in value. The average basket values for New World and Four Square during 2019 were [[redacted]] and [[redacted]] respectively.[93] [[redacted]], the average basket value for PAK'nSAVE during 2019 was [[redacted]].[94] However, Figure 2.4 illustrates that the most common shopping visits across all of FSNI banners are small in value, with frequency typically decreasing as basket value increases.

### Finding that a main shop occurs at one location and typically at a major retailer

78. The Commission states that:[95]

> Our consumer research indicates that most consumers buy groceries for their main shop in one location and that they typically prefer to use one of the major grocery retailers for this main shop.

79. This finding by the Commission is based on the response to question nine of its own survey in which respondents were asked to select their main store, being the store or stores at which that they spend the most or do most of their grocery shopping.[96] Participants were able to select a maximum of two stores as their main store from a list of retailers (eg, New World) or retailer type (eg, an ethnic supermarket).[97]

[93] HoustonKemp analysis of data provided by FSNI. We note that the average basket value is similar for FSSI, with the average basket values for New World and Four Square during 2019 amounting to approximately [[redacted]] and [[redacted]], respectively – averages provided by FSSI.

[94] HoustonKemp analysis of data provided by FSNI. We note that the average basket value is similar across FSSI's PAK'nSAVE stores, amounting to an average of approximately [[redacted]] during 2019 – average provided by FSSI.

[95] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 92-93, para 4.4.

[96] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 78 and 492, para 4.4

[97] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 492.

80. The majority of participants (approximately 80 per cent) selected only one option as their main store,[98] with the Commission drawing on this response to infer that most consumers buy groceries for their main shop in one location.

81. However, the more likely reason for participants selecting one option for their main store is the specification of a main store as being the place where they spend or buy the most.[99] Although the Commission draws on this response to conclude that most consumers buy groceries for their main shop in one location, the results simply show that most consumers can identify one store as being a place where they spend or buy the most. It does not follow that this is the store in which they undertake a single 'main shop', as distinct from the store at which they shop at more frequently.

82. For example, a customer who responded to the Commission's survey selected New World as their main store, indicating they visited this store six times per week and spending a total of $300+ per week.[100] However, this same customer also indicated that they shop at Countdown once per week, spending between $200 and $300 in that one shop. As such, although this customer may spend more in total at New World, it is likely that they undertake one large shop at Countdown and a number of smaller shops at New World.

83. In addition to the majority of participants selecting only one option as their main store, most also selected a major grocery retailer as their main store.[101] The Commission draws on this response to conclude that consumers typically prefer to use one of the major grocery retailers for their main shop.[102] However, the response to this question indicates only that most consumers either spend or buy the most at a major grocery retailer, but not that this retailer is necessarily where a consumer undertakes a main shop.[103]

84. The definition of a main store provided as part of question nine affects the insights that can be drawn about how consumers shop. Put another way, the response to question nine provides insight into where consumers spend or buy the most but does not convey how frequently they shop or how much they spend or buy at other stores relative to their selected main store. As such, it does not allow for any conclusion as to where consumers undertake a main shop.

85. In contrast to the Commission's finding that consumers have one location for their main shop, Ipsos found that few participants shopped for groceries only at a supermarket, with many selecting more than a one-shop retailer as places at which they mainly do their grocery shopping.[104] Consistent with this finding, if the number of main stores selected is divided by the number of participants in Ipsos' study, each participant selected an average of 2.6 stores as a place at which they mainly shop.[105]

86. Further, the Commission's survey found that less than 25 per cent of respondents typically visit only one grocery store per week, suggesting that most consumers regularly shop at multiple different grocery stores every week.[106]

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[98] Of the 11,895 respondents that reported a main store, 9,537 selected one store and 2,358 selected two main stores.

[99] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 492.

[100] Assetid 246537 from the Commission's cleaned survey data. We note that this customer also selected that they tend to make one or two large shop(s)/get one or two large order(s) per week.

[101] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 462, para F98 and figure F15.

[102] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 78, para 4.4.

[103] See paragraphs 81-82.

[104] See paragraph 59 and Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 34.

[105] Calculated as the sum of the total number of selected main shops (152) by the number of participants (58). See Ipsos, *Consumer behaviour and preferences in the New Zealand retail grocery sector: Consumer study report*, July 2021, p 35, table 6.

[106] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 457, para F87 and figure F9.

### 2.2.2 Factors driving store choice

87. The Commission contends that price and convenience are the main drivers of the choice of store for a main shop, with price being relatively more important for consumers doing one or two larger shops.[107]

88. By contrast, we explain below that the principal driver of store choice is the ease of location and that the role of price in store choice relates to the selection of a specific store, and not the Commission's classification of type of shopping missions.

#### Main driver of store choice

89. The Commission states that:[108]

> While consumers choose where to shop based on a range of factors which can vary by type of shopping mission, convenience and price are key drivers of store choice, and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.

90. The Commission's survey asked respondents to select from 19 options to indicate why they choose to shop at their main store, with respondents asked to select all applicable reasons.[109] In addition, respondents were asked to select which of the same 19 options represented the 'single most important reason' why they choose to shop at their main store.[110]

91. The Commission states that the results of the survey indicate that there is a wide range of reasons why respondents choose to shop at their main store, but that convenience and low prices were the most commonly selected key drivers.[111] The Commission bases this statement on the ranking of the respondents' choice as to the single most important reason for their chosen main store, where:

    a. the first most selected option was convenience; and

    b. the second most selected option was low prices overall.

92. However, despite low prices being the second most selected reason, it only accounted for approximately 15 per cent of the 11,880 respondents to this question. Put another way, almost 85 per cent of respondents did not consider price as the most important reason for choosing their main store.

93. Further, in response to the question that required respondents to select **all** of the reasons why they shop at their main store, convenience was the first most commonly selected reason for a consumer's choice of main shop whereas low prices overall was the fifth. A higher proportion of respondents selected 'familiarity with the store/service', 'easy parking' and 'wide choice of products' than low prices.[112]

94. Indeed, only 30 per cent of respondents selected low prices overall as a reason for selecting their main store whereas almost 50 per cent of respondents selected convenience.[113] Consequently, approximately 70 per cent of consumers did not consider low prices as one of the reasons as to why they shop at their main store.

95. Summarising, the results of the Commission's survey in relation the drivers of store choice indicate that approximately 15 per cent of respondents highly value low prices when selecting their main store,

[107] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 80, 94, 96, paras 4.10, 4.77 and 4.81.

[108] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[109] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 493.

[110] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 493.

[111] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 466, para F105.

[112] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 467, figure F20.

[113] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 467, figure F20.

but most consumers (approximately 70 per cent) do not consider low prices to be an important factor. In contrast, almost 50 per cent of consumers consider convenience to be an important factor when selecting their main store.

96. In addition, the Commission appears to interpret convenience as being synonymous with the ease of shopping for all products in one location, ie:[114]

> While consumers choose where to shop based on a range of factors which can vary by type of shopping mission, convenience and price are key drivers of store choice, and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.

97. However, in its survey, the Commission defined convenience as 'convenient/easy to get to', suggesting that, for respondents, convenience was taken to be the location of the store as distinct from the convenience of having all shopping options in one location. Moreover, the Commission's survey included 'wide choice of products' as a separate option, with this likely to capture the convenience of shopping for a wide range of products in one location.

98. It follows that a careful review of the survey data shows that the key driver of store choice is the ease of location, and that preliminary findings expressed by the Commission in relation to prices and the convenience of being able to purchase all products in one location as being key drivers are not consistent with or able to be discerned from the evidence obtained from its own survey.

### Relationship between drivers of store choice and shopping frequency

99. The Commission states that:[115]

> Our preliminary finding is that the key drivers of store choice vary to some degree between different types of shopping missions. Although convenience is the key driver of store choice across all types of shopping missions, price appears to be a relatively more important consideration for consumers doing a larger shop.

100. The Commission bases this finding on respondents' single most important reason for selecting their main store. In particular, the Commission analyses the drivers of store choice by:

    a. splitting the respondents into three groups based on how they usually shop for groceries each week, ie, the answer they gave to question four, being either:[116]

        i. I tend to make one or two large shop(s)/get one or two large order(s);

        ii. I tend to do one or two larger shop(s)/order(s) and a few smaller shop(s)/order(s); or

        iii. I do several smaller shops/orders; and

    b. estimating the drivers of store choice for each of these groups of respondents, ie, the proportion of respondents in each group that selected a particular option as the single most important reason for selecting their main store.

101. However, we explain at paragraphs 64 to 70 above that question four is ambiguous, and does not allow for any conclusion as to how consumers shop for groceries. In particular, respondents' answers to question four do not accurately demonstrate the types of shopping missions that they undertake. It follows that analysing the drivers of store choice by reference to respondents' answers to question four does not allow for an assessment of the drivers of store choice by mission type.

[114] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[115] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 96, para 4.81.

[116] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 490.

102. Although the Commission suggests that there is a relationship between shopping missions and drivers of store choice, any such relationship appears to be driven by choice of main store, not shopping mission. Specifically, selection of low prices is largely related to the selection of PAK'nSAVE as a main store, with approximately 91 per cent of respondents that selected low prices as the key driver of their main store also selecting PAK'nSAVE as this main store.[117] This relationship is largely consistent across respondents when evaluated under the Commission's classifications of shopping behaviour, ie:[118]

a. for those respondents selecting that they tend do several smaller shops/orders, approximately 90 per cent of respondents that selected low prices as the key driver of their choice of main store also selected PAK'nSAVE as their main store;

b. for those responds selecting that they tend to do one or two larger shop(s)/order(s) and a few smaller shop(s)/order(s), approximately 91 per cent of respondents that selected low prices as the key driver of their choice of main store also selected PAK'nSAVE as their main store; and

c. for those responds selecting that they tend to make one or two large shop(s)/get one or two large order(s), approximately 93 per cent of respondents that selected low prices as the key driver of their choice of main store also selected PAK'nSAVE as their main store.

103. The percentage of respondents that selected low prices overall as their most important reason for shopping at their main store differs between respondents when evaluated under the Commission's classifications of shopping behaviour as a result of differing proportions that shop at PAK'nSAVE as their main store. Specifically, for those respondents selecting that they tend do several smaller shops/orders, approximately 27 per cent shop selected PAK'nSAVE as their main store.[119] In contrast, for those respondents selecting that they tend to make one or two large shop(s)/get one or two large order(s), approximately 39 per cent selected PAK'nSAVE as their main store.[120]

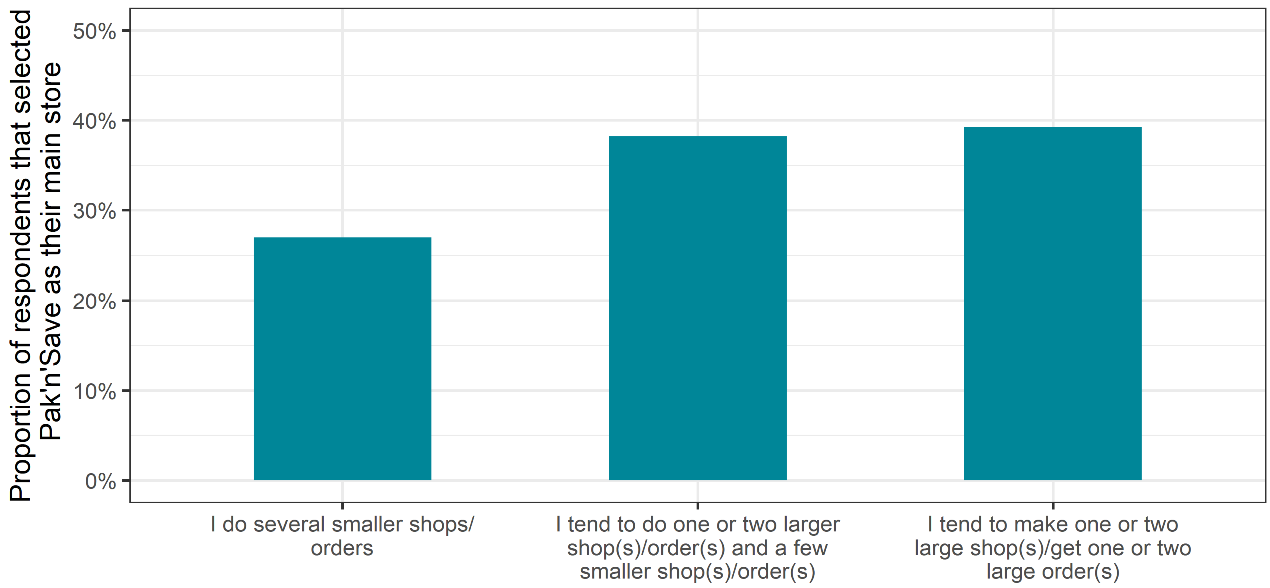
[117] Calculated using the Commission's cleaned dataset, based on those respondents that provided a main store, ie, those respondents that either specified that they did not have a main store or did not provide an answer were excluded from the analysis.

[118] Calculated using the Commission's cleaned dataset, based on those respondents that provided a main store, ie, those respondents that either specified that they did not have a main store or did not provide an answer were excluded from the analysis.

[119] Calculated using the Commission's cleaned dataset, based on those respondents that provided a main store, ie, those respondents that either specified that they did not have a main store or did not provide an answer were excluded from the analysis.

[120] Similarly, for those responds that selected that they tend to do one or two larger shop(s)/order(s) and a few smaller shop(s)/order(s), approximately 38 per cent selected PAK'nSAVE as their main store. Calculated using the Commission's cleaned dataset, based on those respondents that provided a main store, ie, those respondents that either specified that they did not have a main store or did not provide an answer were excluded from the analysis.

Figure 2.5: Proportion of respondents that selected PAK'nSAVE as their main store




*Notes and sources: HoustonKemp analysis of the Commission's cleaned survey data. Note that the graph reflects those respondents that selected PAK'nSAVE as a main store as a proportion of respondents that identified a main store – ie, the analysis excludes any respondents that either selected that they do not have a main store or did not select a main store.*

104. The higher proportion of respondents selecting PAK'nSAVE in the latter group is driving the higher proportion that selected low prices as their key driver of store choice. Put another way, the relationship is between PAK'nSAVE shoppers and low prices, not mission type and low prices.

105. It follows that the survey results provide no support for the Commission's contention that price appears to be a relatively more important consideration for consumers doing a larger shop.

### 2.2.3 Competition from other retailers

106. The Commission's preliminary finding is that other grocery retailers are unlikely to constrain the major grocery retailers to a significant extent, principally on the basis that they cannot provide for a consumer's main shop, ie:[121]

> The fringe of other competitors is made up of a range of retailers that provide options for some consumers. However, they have a limited impact on the major grocery retailers. An important reason for this is that most consumers regularly carry out a main shop from one supermarket and the major grocery retailers are uniquely placed to offer the convenience of a main shop at a single location.

107. We explain in section 2.1.2 that, by focusing its analysis of competition on a main shop, the Commission's overlooks the majority of shopping trips. For example, although the Commission states that consumers regularly carry out a main shop from one supermarket, the results of its own survey indicate that less than 25 per cent of respondents typically visit only one grocery retailer per week.[122] Rather, 75 per cent of respondents visit two or more different grocery retailers each week, with

[121] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 4.

[122] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 457, para F87, figure F9.

respondents visiting an average of 2.4 different grocery stores each week.[123] As such, the majority of respondents shop at more than one store every week.

108. Moreover, the results of the Commission's survey found that 40 per cent of respondents visited a mix of major grocery retailers and other grocery retailers during a typical week.[124] Put another way, the Commission's own survey evidence indicates that 40 per cent of respondents split their weekly basket across major grocery retailers and other stores, with this finding suggesting that a number of consumers consider other grocery retailers as an alternative to the major grocery retailers for various items in their weekly basket.

109. For those respondents that shop across both major grocery retailers and other stores during a typical week, other grocery retailers account for an average of 25 per cent of their weekly spend.[125] In other words, on average, consumers that shop at both major grocery retailers and other stores purchase almost one quarter of their weekly basket (by value) at other grocery retailers.

110. It follows that a number of respondents consider other grocery retailers to represent an alternative to the major grocery retailers and that this is likely to have a considerable impact on the amount that they purchase from the major grocery retailers.

### 2.2.4 Competition between major grocery retailers

111. We explain in section 2.1 that the Commission's preliminary findings is that major grocery retailers are each other's closest competitors, but there is limited competition between the banners on account of differentiation, ie:[126]

> Our preliminary view is that competition between the major grocery retailers is also not effective. Major grocery retailers differentiate their retail banners in ways that appear to limit competition between them, particularly on price.

112. The Commission's survey collected data on the stores at which respondents typically shopped during a given week. However, the Commission does not present summary statistics on the number of people that shop between the three large banners of Countdown, New World and PAK'nSAVE.

113. In contrast, we have analysed the data available to the Commission to determine the extent to which consumers commonly shop between the large banners.

114. Of the 12,097 respondents in the Commission's cleaned dataset, 10,381 indicated that they typically shop with at least one of Countdown, New World and PAK'nSAVE. For these respondents, we estimated the proportion that shopped:

   a. at only one of the large banners, ie, respondents may also shop at other retailers but combine this with only one of Countdown, New World and PAK'nSAVE;

   b. across any two of the large banners, ie, respondents may also shop at other retailers but combine this with a shop at any two of Countdown, New World and PAK'nSAVE; and

   c. across all three of the large banners, ie, respondents may also shop at other retailers but combine this with a shop at all three of Countdown, New World and PAK'nSAVE.

115. We present the results of this analysis in Figure 2.6 below.

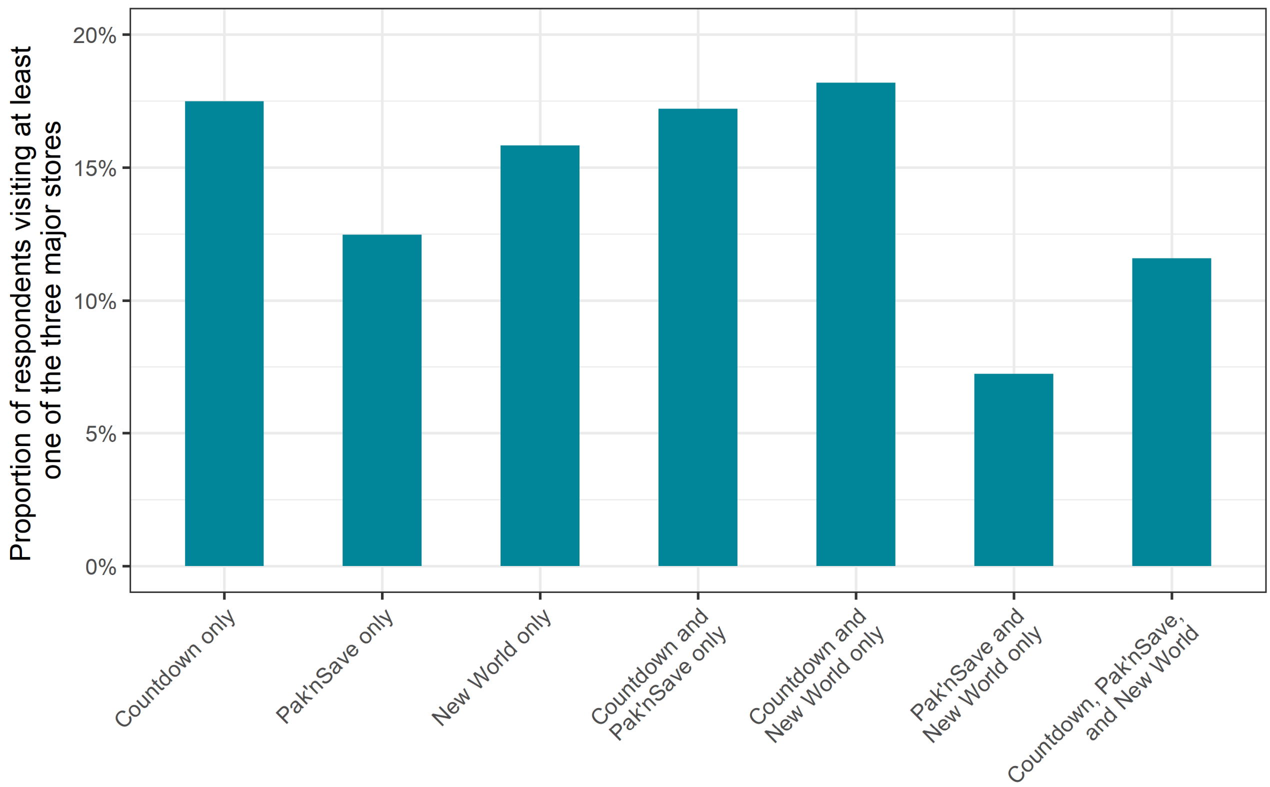
[123] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 457, para F87, figure F9 and HoustonKemp analysis of the Commission's cleaned survey data.

[124] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 459, para F90 and figure F11.

[125] HoustonKemp analysis of the Commission's cleaned survey data.

[126] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 111.

Figure 2.6: Stores visited by those respondents that shop at the large banners




*Notes and sources: HoustonKemp analysis of the Commission's cleaned survey data.*

116. Figure 2.6 indicates that respondents commonly shop across combinations of the large banners, with respondents shopping at an average of 1.7 large banners in a typical week. Specifically, of those respondents that shop with at least one of Countdown, New World and PAK'nSAVE, approximately 46 per cent shop at only one of these retailers, with the remaining 54 per cent shopping at more than one of these retailers.

117. In contrast to the preliminary findings of the Commission, these results suggest that more than half of all consumers do consider the large banners as alternatives to each other, although this applies to the least extent between PAK'nSAVE and New World. These data strongly suggest that the two major grocery retailers compete with each other to attract customers.

# 3. Pricing behaviour and promotions

118. The Commission analysed both price changes and promotions in the local grocery market to determine whether there is effective retail competition, with the results of this analysis presented in attachment E of its draft report.[127] In particular, the Commission examined:

a. the scope, timing and quantum of promotions to assess the extent to which retailers may be accommodating each other by coordinating promotions;[128] and

b. the price response to changes in costs to assess the extent to which cost savings are passed on to consumers, ie, a pass-through analysis.[129]

119. The Commission found that there is some evidence that grocery retailers pass through cost increases more readily than cost decreases and avoid promoting items at the same time, ie:

> There is limited evidence of retailers passing through cost reductions to consumers. As discussed in Attachment E, analysis we have undertaken indicates that most retailers have a substantial proportion of products with estimated pass-through rates significantly less than 100%.[130]
>
> We have also seen some evidence that promotional clashes are avoided for some products…[131]

120. In contrast to the intimations drawn by the Commission, we explain below that the Commission's analysis in relation to promotions and price changes are consistent with dynamic, competitive interactions between the two major grocery retailers. The Commission's analysis shows that price promotions were common, substantial and varied in their form, indicating that there is strong competition between grocery retailers. Moreover, the Commission found no pattern of high correlations between weekly average prices for products within geographic clusters, indicating dynamic competition between grocery retailers and an absence of coordination.

121. Similarly, the Commission's pass-through analysis suggests that competition is dynamic, with grocery retailers passing though cost decreases to consumers.

122. In the two subsections below, we review the basis for the Commission's findings in relation to promotions and pricing behaviour. We explain that the Commission's finding of a high correlation between the promotions of some products does not indicate a lack of competition between major grocery retailers, because:

a. the correlation arises only for a small number of products;

b. the correlation could be caused by a number of factors that do not relate to competition; and

c. it is not clear why any correlation between promotions would be in the interest of grocery retailers.

123. We also explain that the Commission's pass-through analysis does not suggest a stronger tendency for cost increases to be passed through compared to cost decreases.

[127] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, attachment E.

[128] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 138 and 414, paras 5.137 and 5.152.

[129] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 253, 260, 287-288, paras 8.27-8.28 and 8.137-8.139.

[130] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 287, paras 8.137-8.138.

[131] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 141, para 5.152.

## 3.1 Analysis of promotions

124. In examining the state of competition in a market, the presence of sustained, dynamic promotions activity would generally be an indicator of intense, price-based competition and would lend itself to the conclusion that a market was effectively competitive.[132] The primary exception to the drawing of such a conclusion from empirical evidence of active promotional activity would be circumstances where the scope, timing and quantum of promotions were taking place in a coordinated manner, such that the principal competitors in a market were accommodating each other, potentially contrary to the interests of consumers.

125. Consistent with the insights potentially available from the analysis of promotion-related conduct for the nature and intensity of competition in a market, the Commission undertook an extensive, detailed analysis of promotions offered by the major grocery retailers in 2019. The Commission's quantitative analysis involved approximately 430 million records of price and cost data for the major grocery retailers.[133] The Commission's findings from its analysis were that:

    a. promotions were very common – a large number of products are frequently on promotion[134] and approximately half of the revenue from major grocery retailers in 2019 came from sales of products on promotion;[135]

    b. the discounts offered in promotions were substantial – the median discount was between 16 and 25 per cent depending on the type of promotion;[136]

    c. the proportion of revenue from promotions and their prevalence varies by the retail banner;[137] and

    d. there are a range of different types of discounts, including loyalty promotions, multi-buy and fixed discounts – the most common was a fixed discount but this also varied by retail banner.[138]

126. The Commission states that it considers the frequency and prevalence of the major grocery retailers' pricing and promotional practices, in combination with other reward structure and terms and conditions, can confuse consumers.[139] The Commission does not cite any clear evidence for its apparent view that promotional discounts may lead to consumers making poor purchasing decisions. However, it is difficult to imagine that consumers can be substantially confused by the existence of price discounts that are very commonly available across many products in the economy.

127. Acknowledging that potential benefits to consumers, the Commission also states that:[140]

> Where promotions are not misleading and offer genuine savings to consumers, they can provide value to consumers in the form of cost savings and drive price competition.

[132] For example, in its investigation into the supply of groceries by United Kingdom retailers, the UK Competition Commission found that 'temporary promotions on some products, including fuel, to attract consumers and increase total sales (commonly referred to as 'loss leading') may represent effective competition between retailers and may benefit consumers by reducing the average price for a basket of products.' See Competition Commission, *The supply of groceries in the UK market investigation*, April 2008, paras 19, 5.69 and 5.102.

[133] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 416, para E4.

[134] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 424 and 426, para E33, figure E4 and figure E5.

[135] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 420, para E22.

[136] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 428, para E38 and figure E6.

[137] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 421, para E23 and table E2.

[138] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 422-424, para E28, figure E1 and figure E3.

[139] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 299 para 9.15.

[140] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 214, para 7.53.

128. In our opinion, the prevalence, size and variation in promotions offered by the major grocery retailers is consistent with retail grocery sector competition being effective, for a number of reasons, ie:

a. first, promotions are common and substantial, indicating that grocery retailers are working hard to attract customers – if competition between the major grocery retailers was weak, there would be no need for them to offer promotions to the significant extent that the Commission's analysis finds;

b. second, the market is varied and dynamic, with firms using different approaches in terms of the type and value of promotion and the products that benefit from a promotion; and

c. last, the frequent and varied use of promotions is inconsistent with the existence of coordination or accommodation between the major grocery retailers – retailers are not copying each other's promotions, and such a strategy is not even possible when there are so many.

129. These observations are consistent with the Commission's conclusion that the prevalence of discounts makes it more difficult for firms to accommodate each other's conduct.[141]

## 3.2 Analysis of price changes

130. The Commission undertook a range of analyses on the prices of items sold by the major grocery retailers throughout 2019.

131. First, the Commission examined the correlation between weekly average prices for each product and each store. It found no clear pattern of high correlations within geographic clusters of stores, and so concluded that there was 'no obvious evidence of leader-follower type pricing across the stores in the clusters used in this analysis'.[142]

132. In our opinion, this empirical finding is consistent with the existence of dynamic and effective competition between grocery retailers and is inconsistent with any form of coordinating conduct.

133. The Commission noted that there were some products where pricing was very highly correlated across stores in a cluster and that this appears to be due to pricing promotions that alternate across stores of different retail banners within a cluster on a regular schedule.[143] Specifically, the Commission states that:

> We have also seen some evidence that promotional clashes are avoided for some products (see Attachment E).

134. However, a finding that a small number of products had alternating promotions does not indicate that there is a lack of competition between major grocery retailers because:

a. the correlation is only for a small number of products and the Commission said there is no clear pattern of high correlations, as set out above;[144]

b. the correlation in price changes could be for a number of reasons that do not relate to competition between major grocery retailers, eg, it could reflect changes in the cost of purchasing the product from the supplier, where the supplier was determining the schedule of promotions for a particular product; and

[141] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 139, para 5.140.

[142] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 429, para E41.

[143] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 430, para E42.

[144] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 430, para E42.

c. it is not clear how major grocery retailers would benefit from alternating their promotions, or how this would lessen competition – firms seeking to coordinate their conduct to increase profits would usually want to increase prices together, rather than at different times.

135. Drawing on weekly data of price and cost changes, the Commission also examined the effect of an increase in the cost of goods sold (COGS) of at least five per cent on the prices set for grocery products throughout 2019. It calculated the extent of pass-through of the cost change for a product as the difference in the price divided by the difference in the cost, before and after the cost change. For example, if the COGS increased by $10 and the price increased by $5, there would be a 50 per cent pass-through.

136. The Commission identified thousands of instances in which a product's cost in a store increased by more than five per cent. For each retail banner it presumably had hundreds of instances of cost increases.

137. The Commission then calculated the median rate of pass-through for each retail banner. The median rate of pass-through ranged from 0 to 65 per cent for cost decreases and 8 to 75 per cent for cost increases. It concluded that this was:[145]

> suggesting a slightly stronger tendency for cost increases to be passed through compared to cost decreases. However, a very wide range of pass-through rates for individual combinations of products and stores within each retail banner was also found.

138. In the main body of the report, the Commission expressed this finding in less measured terms, stating that:[146]

> There appears to be limited pass-through of cost reductions to consumers…There is limited evidence of retailers passing through cost reductions to consumers. As discussed in Attachment E, analysis we have undertaken indicates that most retailers have a substantial proportion of products with estimated pass-through rates significantly less than 100%.

139. In our opinion, the results of the quantitative analysis undertaken by the Commission are not consistent with a stronger tendency for cost increases to be passed through relative to cost decreases or with limited pass-through of cost reductions.

140. Rather, the Commission's analysis instead provides evidence of retailers passing on both cost increases and cost decreases to consumers and is completely consistent with the presence of effective competition between the major grocery retailers. We draw this conclusion by reference to six observations regarding the reported results of the Commission's analysis, for which underlying data is not available.

141. First, the median rates of cost pass-through for each retail banner referenced by the Commission do not provide information as to whether or not the average rate of cost pass-through for cost increases is higher than for cost decreases. The median rate of pass-through discloses only the middle value in a ranking. It does not provide information as to the distribution of the rates of cost pass-through and it does not indicate which grocery products are more important to customers, in that they represent a higher proportion of spending.

142. For example, the median cost pass-through may be zero per cent if half of the rates of cost pass-through are just below zero, and the other half are around 100 per cent. In this hypothetical example, the mean rates of cost pass-through weighted by revenue may be close to 100 per cent.

143. Second, the rate of consumer price inflation in New Zealand is positive, with prices gradually rising over time. The prices of grocery products in any later point in a particular time period will therefore be

[145] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 431, para E46.

[146] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 287, paras 8.137-8.138.

higher, on average, than at an earlier point in the time period. This means that the Commission's analysis will tend to find higher levels of pass-through for price increases than for price decreases, even when there is no asymmetry in the rate of cost pass-through.

144. Third, changes in prices are affected by factors other than changes in the COGS, such as the demand for a product, or the existence of a promotion. It is unclear to what extent the changes in prices observed by the Commission relate to changes in the COGS, or some other factor.

145. Fourth, grocery retailers compete to provide a wide range of products and on other dimensions such as quality of the store, rather than to supply individual items. A reduction in the COGS for an individual product may lead to a supermarket increasing the quality of its stores, training its staff, or reducing the price of another product. Decisions by a supermarket to alter its offering by reference to any one of these potential alternative dimensions of competition in response to a reduction in the cost of any individual item are still consistent with effective competition. There is no reason to expect that, in an effectively competitive market, when the COGS for one product reduces, the price for that item will also be reduced by the same amount.

146. Fifth, in the detailed description of its analysis, the Commission makes a very weak claim in relation to the small observed difference between the rate of pass-through of cost increases, as distinct from cost decreases. It does not state that the observed difference is statistically significant, but states only that there is a 'slightly stronger tendency' for cost increases to be passed through, as compared to cost decreases.[147] On its face, such a claim is not strong enough to be relied upon to draw any notable conclusion.

147. Finally, even if it could be stated with the degree of statistical significance that there was asymmetry in the extent of pass-through of cost changes at a market-wide level, this does not indicate that there is any problem with the intensity or effectiveness of competition.[148]

148. To summarise, the Commission does not present any evidence that is capable of supporting its claim that there appears to be limited pass-through of cost reductions to consumers, In any case, even if the Commission's claim was true, it is not clear what conclusion, if any, could be drawn as to its implications for the effectiveness of competition.

149. The Commission also undertook an analysis of the correlation of the weekly average price and cost across both retail banners and products within stores and found that the correlation of prices and costs varied a great deal.[149] This finding is consistent with a dynamic and varied environment in which grocery retailers compete across a range of products, rather than on individual items.

150. Furthermore, the Commission found that there is substantially higher rate of pass-through of cost changes that affect both Foodstuffs and Woolworths, as compared to cost changes that affected only one retailer.[150] This finding is also consistent with strong competition between Foodstuffs and Woolworths, such that when only one of them faces an increase in costs, its ability to alter prices is each is constrained by the other. By contrast, in a circumstance where competition was weak, the increase in price when one firm suffered an increase in costs would be expected to be more similar to that when both firms faced a cost increase.

[147] Statistical significance refers to the results from a statistical test. In particular, the p-value of a statistical test conveys the probability of getting, by chance alone, a test statistic that is at least as large as the observed value. If this p-value is smaller than a given threshold, typically five per cent, then the result is statistically significant.

[148] Asymmetry in the extent of pass-through of cost changes can occur even in perfectly competitive markets. See: Ritz, R A, *The simple economics of asymmetric cost pass-through*, Cambridge Working Paper in Economics, 1511, May 2015.

[149] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 433, paras E48-E49.

[150] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 434, para E50.

# 4. Competition in local grocery markets

151. The Commission draws on analysis undertaken by Frontier Economics to examine the extent to which the structure of local grocery markets affects price competition between stores.[151] Specifically, Frontier Economics undertook an analysis of:

   a. the levels of local market concentration in the areas surrounding 694 major grocery stores to assess how variations in concentration across local grocery markets are related to variations in prices;[152] and

   b. a sample of 32 events when stores entered, exited, changed location or rebranded to assess whether these events had an economically significant effect on the prices charged by competing stores within the same local markets.[153]

152. The Commission states that Frontier Economics' analysis suggests that local market concentration has a limited effect on price competition, and concludes that such a finding suggests that competition between major grocery retailers is not effective, ie:[154]

> Overall, the analysis by Frontier Economics suggest that local market concentration appears to have little or no effect on price competition between the major grocery retailers. This is consistent with our preliminary finding that price competition between the major grocery retailers is less than we would expect in a workably competitive market.

153. In relation to Frontier Economics' event or entry and exit analysis, the Commission concludes that the entry or exit of major grocery retailers has a limited effect on the prices charged by close competitor stores, ie:[155]

> Frontier Economics found that there was no systematic relationship between the entry, exit or rebranding of a store and the prices charged by close competitor store in the 12 months after the event. This is consistent with their finding that local market concentration levels appear to have little or no effect on price competition between most of the major grocery retailer banners.

154. The Commission then extends its conclusions from these analyses to support its view that other grocery retailers do not constrain the prices of major grocery retailers at the local, regional or national level, ie:[156]

> The finding that local market concentration appears to have little or no effect on price competition between grocery retailers also appears to confirm that the aggregated effect of competition by other grocery retailers in local markets is not sufficient to increase the intensity of competition at either a local, regional or national level…
>
> The lack of evidence that entry by two new Farro Fresh stores in Auckland constrained the pricing of the major grocery retailers in close proximity to these new openings seems to support the view that that there is little evidence that other grocery retailers have an effect on the prices set by the major grocery retailers…

155. In the material below, we explain that the analysis undertaken by Frontier Economics is not consistent with the Commission's view that competition is not effective in the retail grocery sector, because:

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[151] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 135 and 137, paras 5.118 and 5.127-5.128.

[152] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 135-136, paras 5.118-5.126.

[153] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 137-138, paras 5.127-5.132.

[154] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.125.

[155] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 137-138, para 5.131.

[156] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 136-138, paras 5.126-5.132.

a. the conclusion drawn from Frontier Economics' analysis that local market concentration appears to have little or no effect on prices *at the local level* is completely consistent with competition in the retail grocery sector being effective *at the national level*; and

b. the conclusion drawn from Frontier Economics' analysis that there is no systematic relationship between the entry, exit or rebranding of a store and the prices charged by a *local competitor store* is also completely consistent competition in the retail grocery sector being effective at *the national level*.

## 4.1 Local market concentration

156. Frontier Economics examines whether levels of local market concentration affect local price levels, whilst attempting to take into account other factors that may affect prices. In the section below, we describe Frontier Economics' analysis and assess the reasonableness of the Commission's conclusions in relation to this analysis.

### 4.1.1 Analysis conducted by Frontier Economics

157. Frontier Economics examines whether differences in prices are related to differences in local market concentration for each of the 694 stores included in its sample.[157] To undertake this assessment, Frontier Economics relied on a number of key elements, ie:

a. the measure of prices in each of the stores it was examining;

b. the measure of local market concentration; and

c. other variables that may also affect prices.

158. Frontier Economics uses two measures of local market concentration, ie:

a. the distance weighted share of each major grocery retailer, which is derived from the sum of the distance weighted revenue of stores within the market[158] – the distance weighted revenue of each store is obtained by multiplying the store's revenue by its normalised proximity[159] to the focal supermarket, ie, the one whose prices are being examined; and

b. the proximity to the focal store, which is calculated as the normalised proximity of the nearest banner store to the focal store.

159. Frontier Economics excludes unbranded and unpackaged fruit, vegetables and meat from its analysis to ensure they are comparing products with the same physical characteristics.[160] In our opinion, this decision is likely to exclude many items over which price competition between major grocery retailers takes place, and so limits the reliability of the results.

160. Frontier Economics notes that whilst its two measures of market concentration may affect prices, price may also affect local market conditions, ie, the measures of market concentration are endogenous. For example, a firm may expand into a local area because it observes high prices in that area,

[157] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, pp 20-21.

[158] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 23.

[159] The normalized proximity of the supermarket measures the distance from the focal store as a percentage. A store at the spatial centre of the market will have a weighting of 100 per cent, but a store at the spatial boundary of the market will have a weighting of zero.

[160] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 10.

suggesting high profits.[161] Frontier Economics attempts to control for this when it uses the distance weighted share measure of local concentration.[162]

161. Frontier Economics was unable to find a suitable way to control for endogeneity of the proximity measure of local market concentration. In our opinion, this inability to control for endogeneity of competition renders the proximity measure of local market competition unreliable.[163]

162. In relation to the results of its analysis when using the distance weighted share of each major grocery retailer as the measure of competition, Frontier Economics reports that the effect of concentration is positive and statistically significant at the five per cent level[164] in two out of six instances in urban areas, and three out of five in rural areas.[165] In other cases, the results are not statistically significant at the five per cent level. In other words, the results are mixed, and do not provide a sound basis for concluding that greater local market concentration leads to higher grocery prices.

163. When using the proximity measure of local market concentration, Frontier Economics finds that the effect of concentration is mixed and less clear.[166]

### 4.1.2 Commission's conclusions are not well founded

164. The Commission states that Frontier Economics' analysis suggests that local market concentration has a limited effect on price competition. However, the Commission concludes that this finding suggests that competition is not effective in the retail grocery market, ie:[167]

> Overall, the analysis by Frontier Economics suggest that local market concentration appears to have little or no effect on price competition between the major grocery retailers. This is consistent with our preliminary finding that price competition between the major grocery retailers is less than we would expect in a workably competitive market.

165. In our opinion, the conclusion from Frontier Economics' analysis that local market concentration appears to have limited or no effect on price competition between the major grocery retailers has no implications for the effectiveness of competition.

166. Rather, it simply confirms that competition between the major grocery retailers takes place primarily at a national level, and is consistent with – but not itself determinative of – such competition being effective. When competition primarily takes place at the national level, there is no reason to expect a change in local market concentration to have a significant effect on national or local prices.

167. Had Frontier Economics' analysis found that more concentrated local markets consistently had higher prices, this may have indicated that competition was not as effective as it could be, and that the presence of a new entrant in any particular location could be beneficial for consumers. However, no such finding was drawn from Frontier Economics' analysis.

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[161] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 27.

[162] The use share is the share of each major (calculated without any distance weights) with area and demographic group controls.

[163] Using ordinary least squares regression with an endogenous variable can lead to biased and inconsistent results. See Hausman, J A and Taylor W E, *Panel Data and Unobservable Individual Effects*, Econometrica, Vol. 49, No. 6, 1981, pp 1,377-1,378.

[164] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 30.

[165] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, pp 29-30.

[166] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 32.

[167] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.125.

168. The Commission also finds that the Frontier Economics analysis ‘appears to confirm’ that other grocery retailers do not constrain the prices of major grocery retailers at either the local, regional or national level, stating that:[168]

> The finding that local market concentration appears to have little or no effect on price competition between grocery retailers also appears to confirm that the aggregated effect of competition by other grocery retailers in local markets is not sufficient to increase the intensity of competition at either a local, regional or national level…

169. In our opinion, the finding that local market concentration appears to have little or no effect on price competition between grocery retailers provides no information as regards the intensity of competition at the national level. The findings of Frontier Economics’ analysis cannot be aggregated to the regional or national level.

170. If competition between the major grocery retailers primarily takes place at the national level, changes in concentration at a local level would not be expected to have a significant effect on local prices. For example, we would not expect a change in the degree of market concentration in Remuera to substantially affect competition in the national supply of groceries.

## 4.2 Entry and exit

171. Frontier Economics analyses the effect of exit, entry, location changes and store rebranding events on competitors’ grocery prices. In this section we describe Frontier Economics’ analysis and assess the reasonableness of the Commission’s conclusions by reference to this analysis.

### 4.2.1 Analysis conducted by Frontier Economics

172. Frontier Economics uses a sample of 32 events between April 2016 and March 2019 to evaluate the effect on local market prices when grocery stores entered or exited the local market, changed location or rebranded.[169] Frontier Economics compared weekly prices at the closest competitor stores as between:

   a. the 12 months *prior* to the event; and

   b. the 12 months *following* the event.[170]

173. Frontier Economics’ estimates a fixed effects regression model that controls for store, week and product fixed effects.[171] The effect of the event on prices at the competitor store is the variable of interest in the regressions.[172]

174. Frontier Economics focuses its assessment on price changes that are economically significant, which it defines as those of at least 0.5 per cent up or down.[173] On this basis, Frontier Economics concludes

[168] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.126.

[169] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, pp 34-35.

[170] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 35.

[171] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 36.

[172] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 37.

[173] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 37.

that most events had no economically significant effect on price levels, ie, price levels do not change by more than 0.5 per cent.[174]

### 4.2.2 Commission's conclusions are not well founded

175. The Commission concludes that the entry or exit of major grocery retailers has a limited effect on the prices charged by close competitor stores, ie:[175]

> Frontier Economics found that there was no systematic relationship between the entry, exit or rebranding of a store and the prices charged by close competitor store in the 12 months after the event. This is consistent with their finding that local market concentration levels appear to have little or no effect on price competition between most of the major grocery retailer banners.

176. We agree with the Commission that the results from Frontier Economics' entry and exit analysis are consistent with its analysis examining the effects of local market concentration, ie, Frontier Economics does not find a consistent relationship between local market structure and prices.

177. However, the Commission also relies on Frontier Economics' analysis to draw the conclusion that other grocery retailers have a limited effect on the prices charged by nearby major grocery retailers, ie:[176]

> The lack of evidence that entry by two new Farro Fresh stores in Auckland constrained the pricing of the major grocery retailers in close proximity to these new openings seems to support the view that that there is little evidence that other grocery retailers have an effect on the prices set by the major grocery retailers…

178. In our opinion, Frontier Economics' finding that entry and exit events have a limited effect on prices at nearby competitor large retailer stores is consistent with competition between large retailers primarily taking place at a national level.

179. However, Frontier Economics' analysis does not provide any empirical or analytical basis for the Commission's preliminary finding that other grocery retailers – individually or in aggregate – do not constrain the prices set by major grocery retailers.

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[174] Frontier Economics, *Econometric analysis of the New Zealand Retail Grocery Sector*, Report for the Commerce Commission, July 2021, p 38.

[175] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 137-138, para 5.131.

[176] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, pp 137-138, para 5.131.

# 5. Conclusion

180. Our detailed examination of three of the forms of empirical evidence relied upon by the Commission shows that none of the evidence is consistent with the Commission's preliminary finding that competition is not effective in the retail grocery sector. In particular, the empirical evidence as to:

a. the nature of competition, as revealed in the data underpinning the Commission's own survey and a qualitative study undertaken by Ipsos, offers no support for either the Commission's classification of and emphasis on a 'main shop' or its related contention that, with their more limited or targeted range of products, other grocery retailers 'are not a serious competitive constraint on the major grocery retailers';[177]

b. the nature and extent of promotions is not consistent with any systematic accommodating conduct, while the major grocery retailers' price responses to cost changes provide no tangible evidence of a 'slightly stronger tendency' to pass through cost increases than cost decreases;[178] and

c. the absence of any finding that local market concentration and/or entry and exit events affect local price competition does not imply that the aggregated effect of other grocery retailers is 'not sufficient to increase the intensity of competition at either a local, regional or national level'.[179]

181. Rather, in our opinion the available empirical evidence as to the nature of competition, the extent of promotions, the pass through of cost changes, and the primarily national basis on which price competition takes place is all either consistent with or positively supports a conclusion that competition in the retail grocery sector is effective.

[177] See paragraph 28; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 10.

[178] See paragraph 137; and Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 431, para E46.

[179] See paragraph 154; and Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 136, para 5.126.

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# International comparisons of grocery prices

A report for Foodstuffs

9 September 2021

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## Disclaimer

# Contents

# Figures

# Executive summary

1. We have been asked by Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI) to prepare this report in response to the market study into the retail grocery sector undertaken by the Commerce Commission (the Commission).

2. The essence of the Commission's preliminary findings is that the major grocery retailers amount to a duopoly and choose strategies that limit the extent to which they compete directly with each other.[1] In light of that finding, the Commission's preliminary view is that competition is 'not effective' in the retail grocery sector.

3. These findings rely on five forms of empirical evidence as to the nature and intensity of competition in the retail grocery sector.[2] The purpose of this report is to examine the Commission's interpretation of the evidence in relation to the comparison of the price of groceries in New Zealand and internationally.

4. The Commission undertook a comparison of the price of groceries in New Zealand and the price in several other countries as part of the preliminary findings of its market study. The Commission notes that it is difficult to compare price levels between countries, but nevertheless concludes that the prices for groceries in New Zealand are high by international standards, ie:[3]

> While it is difficult to compare grocery prices internationally, a range of data appears to show that New Zealand ranks in the top 10 most expensive grocery markets out of all 38 OECD countries.

5. We explain in section 2 that the Commission's comparisons of grocery prices in New Zealand relative to other countries have a number of shortcomings that limit the ability to draw any conclusions as to the level of competition in New Zealand's retail grocery sector.

6. Specifically, we explain that various factors are likely to affect observed differences in grocery prices, including variations in the cost of providing grocery services and in the demand for such services. The Commission has not fully controlled for these factors and so no conclusion can reasonably be drawn as regards the degree of competition between grocery retailers in New Zealand, as compared to other countries.

7. In section 3 we explain that, although international price comparison analysis allows for limited findings in relation to competition, the Commission's analysis would be improved by adjusting prices using purchasing power parity (PPP) rather than market exchange rates. Specifically, we highlight that PPP is the appropriate measure of exchange rate because grocery services are not traded between New Zealand and other countries, with PPP recognised by the Organisation for Economic Co-operation and Development (OECD) as being appropriate for comparing price levels between countries.[4]

8. We also explain that the Commission's results change substantially when PPP exchange rates are used instead of market exchange rates.[5] New Zealand ranks approximately in the middle of the OECD countries that the Commission examines using the PPP exchange rate when we exclude alcohol and tobacco, which are heavily taxed in New Zealand.

[1] See paragraph 18 below.

[2] See paragraph 19 below.

[3] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 8.

[4] See section 3.1.

[5] See section 3.2.

9. On these mainstream considerations and adjustments to the Commission's analysis, we conclude that New Zealand does not appear to have high grocery prices by international standards. However, such an analysis still does not take into account a number of factors that vary between countries and can affect grocery prices. It is therefore still not possible to draw any conclusion from this analysis on the extent to which there may be any variation in the degree of competition between grocery retailers across countries.

10. We also demonstrate that grocery prices in New Zealand have increased at a very similar rate to those in Australia over the past ten years, despite the fact that Australia has more grocery retailers than New Zealand, including Aldi, which has grown substantially during this period.[6] This is consistent with the degree of competition being similar in Australia and New Zealand, despite this difference in the number of grocery retailers.

11. Finally, in section 4 we explain that the level of grocery prices in New Zealand relative to other countries bears little relationship to the level of profits generated by the major grocery retailers, even though the profitability of the major grocery retailers is a principal source of empirical evidence for the Commission's preliminary assessment that competition is not effective.

12. In particular, we show that even if the prices of all major grocery retailers were to fall such that:

    a. the profits of FSNI and FSSI were reduced such that their returns on average capital employed (ROACE) were at approximately the mid-point of the Commission's contended range for weighted average cost of capital (WACC), being 5.3 per cent; then

    b. New Zealand's international ranking in terms of the level of grocery prices would not alter to any material degree.

13. The implication of the very low sensitivity of New Zealand's grocery price ranking to different hypothetical profit levels for major grocery retailers is that the current level of grocery prices in New Zealand cannot be explained to any meaningful extent by the nature or effectiveness of competition in the retail grocery sector.

14. Put another way, even if the Commission's analysis of profitability in the grocery sector was valid and soundly based – which separate analysis strongly suggests it is not[7] – and even if the recommendations canvassed by the Commission reduced profits such that the return on capital was the same as the cost of capital, no material change could be expected in New Zealand's international ranking of grocery prices.

15. It follows that the outcomes of the Commission's international ranking of grocery prices are not the result of profits being above any reasonable level and cannot be drawn upon to conclude that competition in the retail grocery sector is not effective. It must be that other factors are principally responsible for the international price ranking conclusions drawn by the Commission.

[6] See section 3.3.

[7] Incenta, *Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability*, September 2021.

# 1. Introduction

16. We have been asked to prepare this report by the two Foodstuffs cooperatives, ie, Foodstuffs North Island (FSNI) and Foodstuffs South Island (FSSI). The context for our report is the market study into the retail grocery sector undertaken by the Commerce Commission (the Commission).

17. The Commission was required under section 51(1) of the Commerce Act 1986 to undertake a study into any factors that may affect competition for the supply or acquisition of groceries by retailers in New Zealand,[8] and has set out its preliminary findings in a draft report released on 29 July 2021.[9]

18. The essence of the Commission's preliminary finding is that the major grocery retailers amount to a duopoly and choose strategies that limit the extent to which they compete directly with each other.[10] In light of that finding, the Commission's preliminary view is that competition is 'not effective' in the retail grocery sector,[11] ie:[12]

> Our preliminary finding is that while there are a number of different retailers operating, the sector is dominated by the major grocery retailers and they appear to be each other's closest competitors. We have seen no evidence to suggest that other grocery retailers constrain the major grocery retailers to a significant extent for a consumer's main shop in any local market(s), either individually or together.
>
> In competition terms, we refer to this as a duopoly with a fringe of other competitors. We have found that the major grocery retailers choose strategies that limit the extent to which their retail banners compete directly with each other, particularly on price. For example, we have seen evidence that the major grocery retailers actively monitor one another's price levels for specific products with the aim of managing specified pricing differences between their retail banners.

19. These findings rely on five forms of empirical evidence as to the nature and intensity of competition in the retail grocery sector, ie:

    a. an analysis of the major grocery retailers' profitability in which the Commission examines whether they earn profits that are above what would be expected in a workably competitive market;[13]

    b. an analysis of data drawn from a consumer survey undertaken by the Commission and a qualitative study performed by Ipsos as to the nature of competition in the retail grocery sector;[14]

    c. an analysis by the Commission of the major grocery retailers' prices and costs that examines:[15]

        i. the nature and extent of promotions; and

        ii. the extent to which cost changes are passed through into price changes;

[8] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 7, para 1.2.

[9] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021.

[10] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 299, paras 9.10 and 9.12.

[11] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 298, para 9.8; and Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 3.

[12] Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 11.

[13] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 37-51, paras 3.7-3.64.

[14] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, chapter 4.

[15] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, attachment E.

d. an analysis by Frontier Economics of the price effects of variations in the degree of local market competition, as indicated by:[16]

   i. differing levels of local market concentration; and

   ii. store entry and exit events; and

e. a comparison undertaken by the Commission of the price of groceries in New Zealand and the price of groceries internationally.[17]

## 1.1 Scope of our report

20. In this report, we examine the Commission's interpretation of the available empirical evidence and assess the reasonableness of its preliminary findings in light of that evidence. Specifically, we examine the evidence available to the Commission under item (e), ie, comparison of the price of groceries in New Zealand and internationally.

21. In a separate report, we examine the evidence available to the Commission in relation to items (b), (c) and (d), ie, the nature of competition in the retail grocery sector, the major retailers' prices and costs, and the price effects of variations in the degree of local market competition.[18] The Commission's profitability analysis is assessed in a separate report prepared by Incenta.[19]

## 1.2 Structure of the report

22. We have structured this report as follows:

a. in section 2, we describe the Commission's international price comparison analysis and explain that it has a number of shortcomings that limit the ability to draw any conclusion as to the degree of competition in New Zealand's retail grocery sector;

b. in section 3, we explain that although international price comparison analysis allows for limited findings in relation to competition, the Commission's analysis would be improved by adjusting prices using purchasing power parity (PPP) rather than market exchange rates; and

c. in section 4, we demonstrate that the level of grocery prices in New Zealand relative to other countries bears little relationship to the level of profits generated by the major grocery retailers.

[16] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 135-138, paras 5.116-5.132.

[17] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 51-66, paras 3.65-3.130.

[18] HoustonKemp, *Empirical evidence of grocery sector competition*, 9 September 2021.

[19] Incenta, *Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability,* September 2021

# 2. International price comparison analysis

23. The Commission undertook a comparison of the price of groceries in New Zealand and the price in several other countries as part of the preliminary findings of its market study. The Commission notes that it is difficult to compare price levels between countries, but nevertheless concludes that the prices for groceries in New Zealand are high by international standards, ie:[20]

> While it is difficult to compare grocery prices internationally, a range of data appears to show that New Zealand ranks in the top 10 most expensive grocery markets out of all 38 OECD countries.

24. In this section we explain that the Commission's comparisons of grocery prices in New Zealand relative to other countries have a number of shortcomings that limit the ability to draw any conclusions as to the level of competition in New Zealand's retail grocery sector.

25. Specifically, we explain that various factors are likely to affect observed differences in grocery prices, including variations in the cost of providing grocery services and in the demand for such services. The Commission has not fully controlled for these factors and so no conclusion can reasonably be drawn as regards the degree of competition between grocery retailers in New Zealand, as compared to other countries.

26. In the remainder of this section, we summarise the Commission's analysis, and then explain the basis for our opinion that it does not provide insights into the degree of competition between grocery retailers in New Zealand.

## 2.1 Commission's methodology and results

27. The comparisons presented by the Commission of grocery prices in New Zealand against those in member countries of the Organisation for Economic Co-operation and Development (OECD) are drawn from:

    a. OECD data for national annual average prices and expenditures for various classes of products, inclusive of tax, most recently available for 2017 (for prices) and 2019 (for expenditures);[21]

    b. the World Bank's International Comparisons Program (ICP) data for national annual average prices and expenditures for various classes of products, inclusive of tax, most recently available for 2017 (for both prices and expenditures);[22]

    c. Numbeo's data for prices for particular products drawn from user reported information, most recently available for 2021;[23] and

    d. the United States Department of Agriculture's (USDA) data for food and non-alcoholic beverages, as sourced from market research firm Euromonitor and most recently available for 2018.[24]

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[20] Commerce Commission, *Market study into the retail grocery sector Draft report – Executive summary*, 29 July 2021, p 8.

[21] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 401-402, paras D5 and D10.

[22] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 401-402, paras D5 and D10.

[23] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 401, para D6.

[24] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 402, para D9.

28. The Commission creates a combined price index, calculated as the weighted sum of separate price indices for food and non-alcoholic beverages, alcohol and tobacco. For expenditure comparisons, the Commission adds together per capita expenditure across these categories.[25]

29. To account for different currencies across the countries included in its comparison analysis, the Commission compares prices by converting to a common currency using market exchange rates.

30. Using these techniques, the Commission finds that the level of New Zealand's grocery prices ranks highly among the 38 OECD countries – being seventh in the OECD prices dataset and sixth in the ICP prices dataset in 2017. In the Numbeo prices dataset, the Commission finds that New Zealand ranks between eighth and eleventh.[26]

31. Similarly, the Commission finds that New Zealand's expenditure per capita on groceries ranks fifth or higher among OECD countries, using the OECD, ICP and USDA expenditure datasets in 2017.[27]

32. On this analysis, the Commission concludes that the data appears to show that New Zealand grocery prices are high by international standards.[28]

## 2.2 Limitations of international price comparisons

33. Rankings of grocery prices and expenditures across countries cannot themselves offer reliable insights into the degree of competition in the supply of groceries in New Zealand.

34. The Commission does not undertake any calculations, analysis or adjustment in relation to its comparisons of prices and expenditures that seek to normalise or account for factors that might differ between countries, other than the degree of competition. The decision by the Commission to confine its comparisons to a subset of countries that it claims are more similar to New Zealand does not eliminate this problem.

35. We explain below that the comparison of prices between countries can be affected by various factors other than competition, with the Commission acknowledging the limitations of international price comparison analysis.

### 2.2.1 Variation in prices can be driven by a range of factors

36. Variation in the degree of grocery sector competition may affect the relative prices of groceries between countries. However, there are several other potential causes of such price differences, including those that relate to either the demand for groceries and/or the cost of supplying them.

37. The cost of supplying groceries to consumers is affected by a number of factors such as:

    a. local resource endowment and manufacturing capabilities that determine the balance between products that can be sourced locally (and their cost) and those that must be imported;

    b. competition between the firms supplying goods and services to grocery retailers;

    c. costs and conditions associated with the supply of labour and capital that is used in the manufacture, distribution and sale of groceries;

    d. the nature of the grocery products themselves, including:

[25] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 406, paras D28-D30.

[26] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 57, paras 3.101-3.102.

[27] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 58, para 3.103.

[28] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 35.

i. the types and range of products;

ii. the pack sizes of products; and

iii. the quality of products;

e. geographic location, transport costs and trading arrangements that affect costs, particularly for imported goods or for goods that are traded internationally;

f. population size and density that affect the unit costs of storing and distributing groceries;

g. differences in taxation policies as they apply between countries; and

h. different regulatory regimes, eg, as they relate to the planning process or the treatment of imported agricultural products.

38. Differences in the cost of supplying groceries will affect their relative price across countries, irrespective of the level of competition is between grocery retailers.

39. Separately, the demand for groceries will be affected by the tastes and incomes of the population, amongst other factors. Variations in demand between countries will also lead to differences in price, without there being any difference in the level of competition between grocery retailers.

40. The cost of supplying groceries may be higher in New Zealand, relative to some other countries for many reasons, including:

a. the quantity of groceries purchased in New Zealand is relatively small, eg, Tesco in the UK purchases a great deal more groceries than Foodstuffs and a store that purchased a greater quantity of groceries would be expected to be able to secure a lower price;[29]

b. New Zealand is geographically isolated compared to most of the other OECD countries, which may increase the cost of transporting goods;

c. many of the countries used by the Commission are members of the European Union or otherwise enjoy free trade with the European Union, which New Zealand does not – this is likely to increase grocery prices for New Zealand relative to others;[30] and

d. the cost of labour may be higher in New Zealand as a result of factors that affect that demand or supply of labour, eg, some of the OECD countries used by the Commission are likely to have a greater supply of labour than in New Zealand, including through immigration.

41. The demand for groceries may be higher in New Zealand than other countries in the OECD. Many of the OECD countries the Commission uses in its comparison are not generally considered to be highly developed, and so the demand for groceries in those countries is likely to be lower, leading to lower prices for groceries.

42. Consistent with these observations, differences in local labour costs are likely to be an important contributor to variations in grocery prices. The Commission's draft report acknowledges this, noting that income levels are likely to be one determinant of prices.[31]

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[29] The Competition Commission in the UK has previously found that the four largest grocery retailers paid four to six per cent less than the average price. See: Competition Commission, *The supply of groceries in the UK market investigation*, April 2008, appendix 5.3. para 5.

[30] The rules and regulations for the EU trading with New Zealand can be found at https://ec.europa.eu/trade/policy/countries-and-regions/countries/new-zealand/.

[31] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 407, para D34.1.

43. Recognising the problem of the differences between countries, the Commission seeks to identify countries that 'appeared more similar to New Zealand' in terms of the factors it considers most likely to affect price.[32] This may reduce the problem of the many differences between countries that affect prices but, as the Commission acknowledges, it does not eliminate them.[33]

44. In our opinion, it follows that the differences the Commission notes in the grocery prices of various countries could be caused by a combination of many factors, only one of which may be the degree of competition between grocery retailers. It is therefore not possible to draw any reliable conclusions from the Commission's analysis regarding the degree of competition between grocery retailers in New Zealand, relative to other countries.

### 2.2.2 Commission acknowledges difficulties in comparing international grocery prices

45. The Commission's draft report emphasises the difficulty of comparing price levels between countries,[34] and notes that prices are affected by a range of factors in addition to the level of competition between the grocery retailers,[35] including taxation, scale economies and input costs.[36] The Commission states that:[37]

> It is not possible to determine exactly how much of the price differences we observe can be attributed to inter-country differences in competition or any other factors.

46. The Commission identifies a subsample of five OECD countries – Australia, Finland, Iceland, Ireland and Israel – that it considers to be closer comparators to New Zealand, on the basis of:[38]

    a. their economic output per capital, measured as gross national income (GNI) in PPP terms; and

    b. their population and population density.

47. The Commission finds that New Zealand has grocery prices that are either second or third highest within this subsample of comparators.[39] However, while similar in some respects, each of these countries also has significant differences from New Zealand, which the Commission highlights.[40] Consequently, a comparison on the basis of such a subsample is does not correct for the range of factors that affect price levels between countries.

48. The Commission acknowledges the difficulties with international price comparisons, but still uses them to draw cautious conclusions, including:[41]

> While it is difficult to compare grocery prices internationally, the data appears to show that New Zealand prices are high by international standards. New Zealand ranks as one of the most expensive Organisation for Economic Co-operation and Development (OECD) grocery markets, and New Zealanders appear to spend a relatively high proportion of their income on groceries.

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[32] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para D33.

[33] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para D36.

[34] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 35.

[35] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 51 para 3.66.

[36] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 51 and 54, paras 3.66 and 3.84-3.86.

[37] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 61, para 3.113.

[38] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, pp 407-408, para D34 and table D2.

[39] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 62, figure 3.10.

[40] Commerce Commission, *Market study into the retail grocery sector Draft report*, 29 July 2021, p 408, para D36.

[41] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, p 35.

# 3. Adjusted price comparison analysis

49. In section 2 we noted that the Commission compared prices between countries by first converting local grocery prices in each country using market exchange rates. The Commission states that prices can be converted using either the market exchange rate or by using a PPP index of price levels, but it chose to use annual average market exchange rates to convert prices on the basis that:[42]

> This was the same approach adopted in our fuel market study. We consider that grocery products are largely tradeable and therefore the alternative PPP method for converting currencies would not be an appropriate method.

50. In contrast to the Commission's stated reasoning, in this section we explain that although international price comparison analysis allows for limited findings in relation to competition, the analysis would be improved by adjusting prices using a PPP index rather than market exchange rates. Specifically, we highlight that a PPP index is the appropriate exchange rate measure because grocery services are not traded between New Zealand and other countries, with PPP indices recognised by the OECD as being appropriate for comparing price levels between countries.[43]

51. We also explain that the Commission's results change substantially when PPP exchange rates are used instead of market exchange rates.[44] New Zealand ranks approximately in the middle of the OECD countries that the Commission examines using the PPP exchange rate when we exclude alcohol and tobacco, which are heavily taxed in New Zealand.

52. On these mainstream considerations and adjustments to the Commission's analysis, we conclude that New Zealand does not appear to have high grocery prices by international standards. However, such an analysis still does not take into account a number of factors that vary between countries and can affect grocery prices. It is therefore still not possible to draw any conclusion from this analysis on the extent to which there may be any variation in the degree of competition between grocery retailers across countries.

53. Finally, we demonstrate that grocery prices in New Zealand have increased at a very similar rate to those in Australia over the past ten years, despite the fact that Australia has more major grocery retailers than New Zealand, including Aldi, which has grown substantially during this period.[45] This is consistent with the degree of competition being similar in Australia and New Zealand, despite the difference in the number of major grocery retailers.

## 3.1 Appropriate measure of exchange rates

54. As explained by the Commission, a comparison of prices between countries requires that the prices in each country are converted to a common unit, which can be done using either a market exchange rate or a PPP index of price levels.[46]

55. The market exchange rate is the rate of conversion between currencies that is offered on the foreign exchange market.[47] Market exchange rates are easily calculated but are prone to overstate price

[42] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para 3.90.

[43] See paragraph 60 below.

[44] See section 3.2.

[45] See section 3.3.

[46] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para 3.89.

[47] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para 3.89.1.

levels in high-income countries and understate price levels in low-income countries.[48] In comparison, the PPP method adjusts for price differences between countries by dividing the market exchange rate by the national price level. PPP indexes give real national expenditure in a common currency and at a uniform price level.[49]

56. The Commission used annual average market exchange rates to convert prices, with the Commission stating that this was because:[50]

    a. it considers that grocery products are largely tradeable; and

    b. a PPP approach might reduce the price effects in which the Commission is interested if the expenditure items are sufficiently large, since the PPPs are themselves obtained using price-level indices from the country in question.

57. In our opinion, a PPP index is more appropriate for comparing the prices of groceries across most countries because:

    a. retail grocery services in New Zealand are not traded with those in other countries and many large components of the retail cost of supplying groceries are also not traded across countries, including: labour, land, distribution services, professional services and grocery items that are locally produced – high-income countries such as New Zealand are likely to have higher costs for these products and services, which are likely to bias prices upwards when using a market exchange rate; and

    b. groceries are only a small part of a country's gross domestic product (GDP), and so calculating a PPP using expenditure across the economy should not substantially reduce the price effects being investigated, ie, those between grocery items.

58. Using a PPP index is likely to be more appropriate to make comparisons with countries that:

    a. have income levels that are quite different to those in New Zealand; and

    b. do not trade to a great extent with New Zealand.

59. It follows that the use of a PPP exchange rate to compare prices across countries may be least appropriate for Australia, which has similar income levels to New Zealand as well as there being much lower barriers to trade between Australia and New Zealand.

60. The OECD has stated that PPP indices are appropriate for comparing price levels between countries, ie:[51]

> …PPPs are employed... to generate price measures with which to compare price levels, price structures, price convergence and competitiveness.
>
> Public enterprises apply PPPs when comparing their prices and operating costs with those of similar public enterprises in other countries. Private firms operating in different countries apply PPPs for the purposes of comparative analysis involving prices, sales, market shares and production costs.

[48] This is known as the Penn effect. See: Summers, R and Heston A, *The Penn World Table (Mark 5): An expanded set of international comparisons 1950-1988*, Quarterly Journal of Economics, Volume 106, Number 2, May 1991, pp 327-368.

[49] OECD and Eurostat, *Eurostat-OECD Methodological Manual on Purchasing Power Parities (2012 Edition)*, OECD Publishing, Paris, 2012, p 32.

[50] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, para 3.90.

[51] OECD, and Eurostat, *Eurostat-OECD Methodological Manual on Purchasing Power Parities (2012 Edition)*, OECD Publishing, Paris, 2012, paras 1.30-1.31.

61. In its fuel market study, the Commission performed international comparisons of fuel prices using market exchange rates. This is likely to be more appropriate in circumstances in which the single largest contributor of the cost of retail fuel is imported crude oil or refined petroleum, which are internationally traded commodities. By comparison, and contrary to the Commission's assumption, it is unlikely to be reasonable to assume that most inputs to retail groceries sold in New Zealand are internationally traded commodities – indeed, we explain at paragraph 57.a above that many of the inputs to supplying grocery services are not traded across countries.

62. In other circumstances, the Commission itself has made currency conversions using PPP rates of exchange. For example, elsewhere in its retail grocery sector draft report the Commission uses PPP adjustments to compare the incomes of countries for the purpose of identifying those that would be most similar to New Zealand.[52]

63. Further, in its 2012 determination of prices for the unbundled copper local loop (UCLL) the Commission used the mid-point between market exchange rates and PPP exchange rates.[53] In that context, the Commission noted that:[54]

> …the blended approach to currency conversion reflects the components of the UCLL monthly rental service. Approximately 50% of local network costs relate to non-tradeable components (such as labour), and the other 50% relate to tradeable capital inputs.

## 3.2 Price comparisons using a PPP index

64. When a PPP index is used to bring the various currencies into a common unit, New Zealand grocery prices are not high in comparison to other OECD countries.

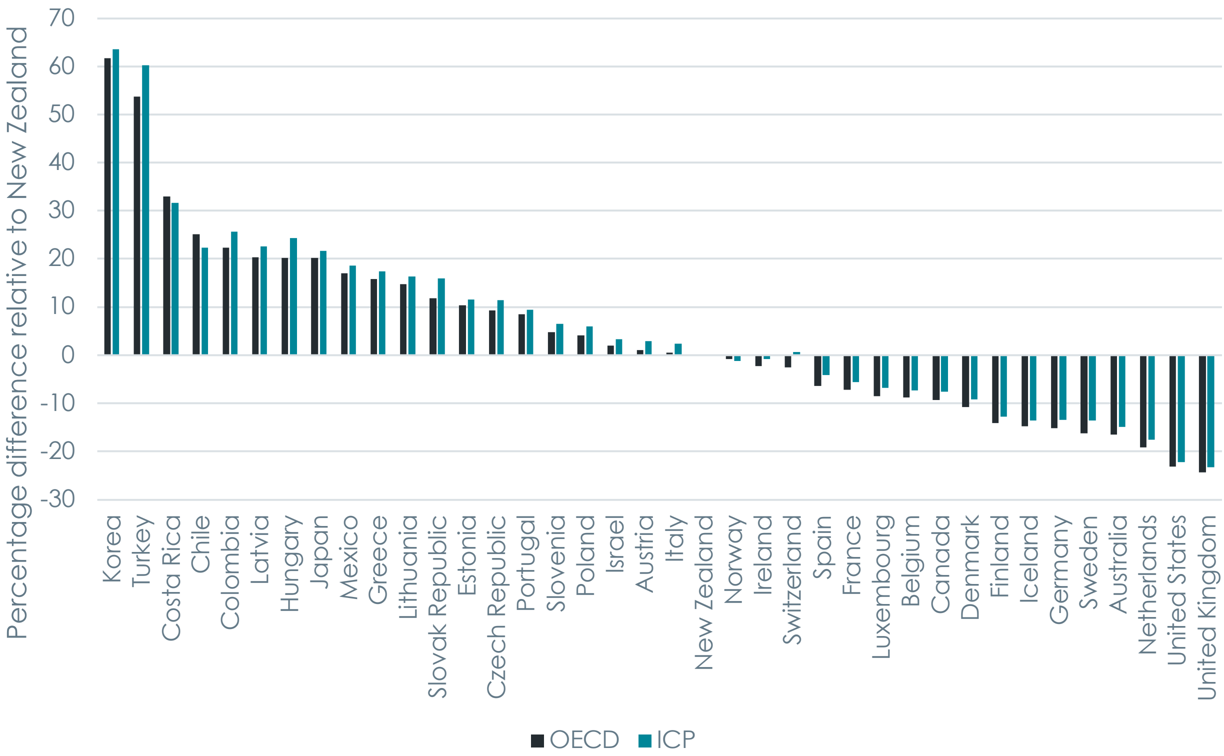
65. Figure 3.1 below illustrates that in 2017 the price of food and non-alcoholic beverages in New Zealand was approximately in the middle of OECD countries. In our opinion, excluding alcohol and tobacco is appropriate given the high level of taxation of these products in New Zealand relative to some other OCED countries.

[52] Commerce Commission, *Market study into the retail grocery sector*, Draft report, July 2021, Table D2, p 408.

[53] Commerce Commission, *Final determination on the benchmarking review for the unbundled copper local loop service*, December 2012, pp 156-158.

[54] Commerce Commission, *Final determination on the benchmarking review for the unbundled copper local loop service*, December 2012, p 370.

Figure 3.1: Differences in food and non-alcoholic beverage prices, relative to New Zealand, 2017




*Sources: HoustonKemp analysis of OECD and ICP data.*
*Notes: See appendix A1 for more details.*

66. On this analysis, we conclude that New Zealand does not have high grocery prices by international standards. However, such an analysis still does not take into account a number of factors that vary between countries that may be driving the differences in their prices. It therefore only allows for a limited conclusion as to effectiveness of competition in the New Zealand retail grocery market.

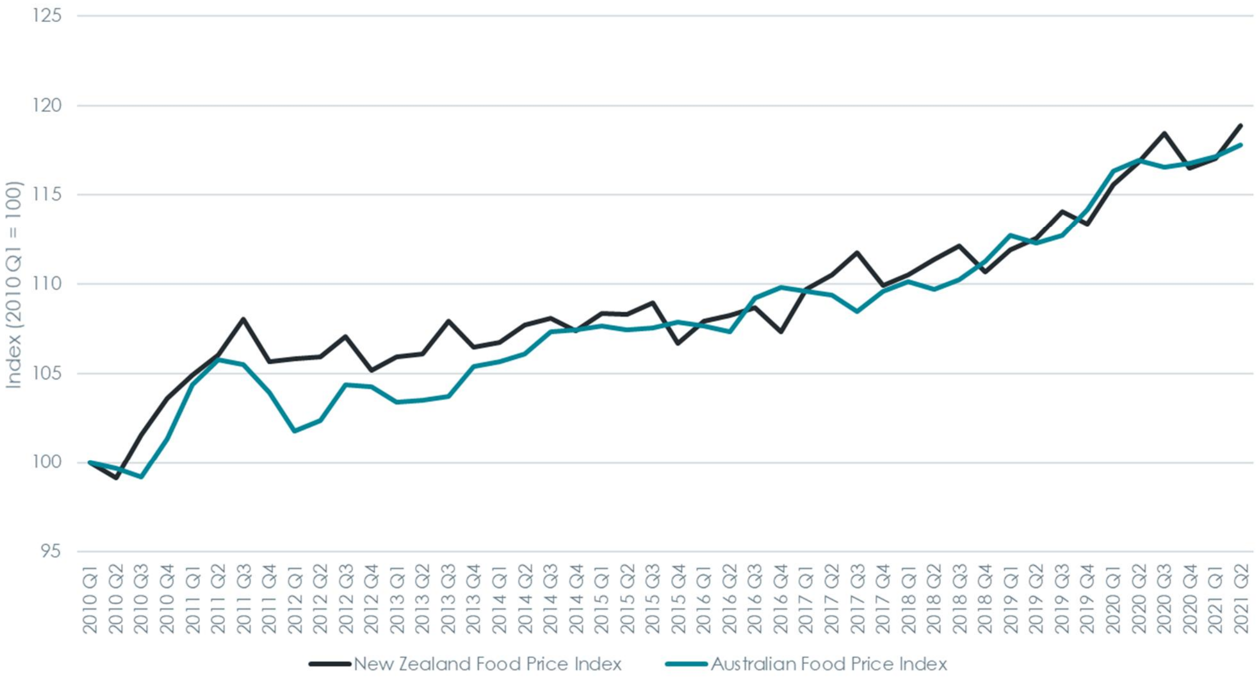
## 3.3 Grocery inflation is similar between Australia and New Zealand

67. Australia has more major grocery retailers than New Zealand, with this difference being present for at least the past ten years. In addition, one of Australia's smaller grocery retailers, Aldi, has expanded significantly since 2010.[55]

68. Notwithstanding the markedly increased presence of Aldi in the Australian retail grocery sector, the price of food in Australia has increased over the period from 2010 at a very similar rate to that of New Zealand, as illustrated in figure 3.2 below.

[55] Aldi had 251 Australian stores in 2011 and in 2021 had more than 500 stores. See: https://www.abc.net.au/news/2021-01-22/aldi-changed-supermarket-shopping-in-australia-in-two-decades/13079180, accessed 1 September 2021.

Figure 3.2: Food price inflation in Australia and New Zealand




*Sources: HoustonKemp analysis of Statistics New Zealand, Food Price Index for New Zealand (Monthly) - CPI004AA, August 2021 and Australian Bureau of Statistics, 6401.0 Consumer Price Index, Table 3 and 4 CPI: Groups, Weighted Average of Eight Capital Cities, Index Numbers and Percentage Changes, Food and non-alcoholic beverages - A2325891R, June 2021.*
*Notes: (1) New Zealand data were converted from monthly to quarterly by taking the mean of the three months in the quarter. (2) The base period for both series is Q1 2010.*

69. We explain in section 2.2.1 that there are many factors that may be driving differences in food prices between Australia and New Zealand. However, the data presented at figure 3.2 suggest that the substantial growth of a grocery retailer in Australia has not had a significant effect on food prices.

70. Put another way, despite there being a larger number of major grocery retailers in Australia and an increasing presence by one major retailer in particular, food prices in Australia over the past ten years have increased at a similar rate to food prices in New Zealand.

# 4. Effect of changed profits on price comparisons

71. In this section we explain that the level of grocery prices in New Zealand relative to other countries bears little relationship to the level of profits generated by the major grocery retailers, even though the profitability of the major grocery retailers is a principal source of empirical evidence for the Commission's preliminary assessment that competition is not effective.

72. In particular, we show that even if the prices of all major grocery retailers were to fall such that:

    a. the profits of FSNI and FSSI were reduced such that their returns on average capital employed (ROACE) were at approximately the mid-point of the Commission's contended range for weighted average cost of capital (WACC), being 5.3 per cent; then

    b. New Zealand's international ranking in terms of the level of grocery prices would barely alter.

73. The implication of the very low sensitivity of New Zealand's ranking in terms of international price comparisons to different hypothetical levels of major grocery retailer levels of profit is that the current level of grocery prices in New Zealand cannot be explained to any meaningful extent by the nature or effectiveness of competition in the retail grocery sector.

74. Put another way, even if the Commission's analysis of profitability in the grocery sector was valid and soundly based – which separate analysis strongly suggests it is not[56] – and even if the recommendations canvassed by the Commission caused major grocery retailer profits to reduce such that their ROACE was the same as the cost of capital, then no material change could be expected in New Zealand's international grocery price ranking.

## 4.1 Commission's analysis not sensitive to different profit levels

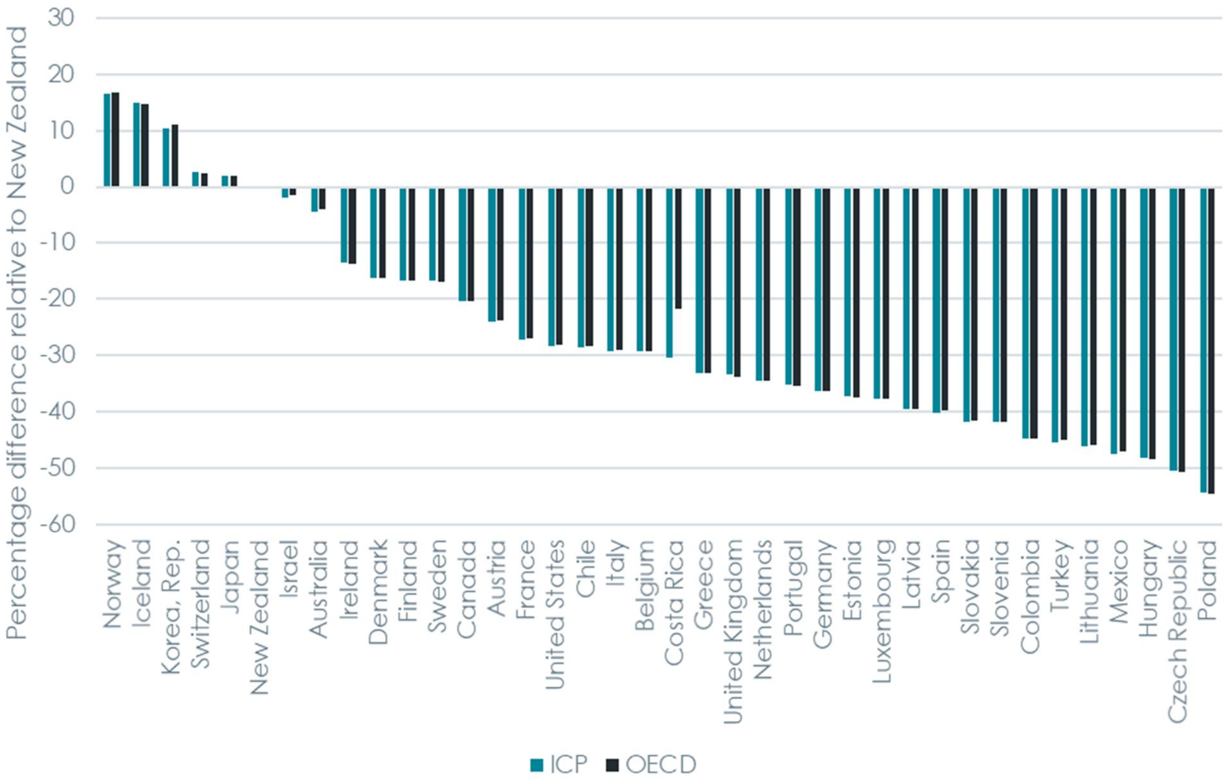
75. Analysis presented to the Commission in the submissions of both FSNI and FSSI shows that the hypothetical adjustment to retail grocery prices to being their whole of business ROACE in line with the mid-point of the Commission's contended range for the WACC of a retail grocery supplier, would be approximately two per cent. Such a price reduction is presumptively consistent with a rate of profit that the Commission appears to consider as both reasonable and consistent with competition being effective.

76. By way of illustration of the effect on New Zealand's international grocery price ranking, we apply a hypothetical price reduction of this same magnitude to all grocery suppliers in New Zealand and examine its effect on the outcomes of the international comparisons undertaken by the Commission.

77. In Figure 4.1, we show the Commission's comparison of all grocery prices including alcoholic drinks and tobacco. On this analysis, New Zealand ranks as the sixth most expensive in the sample.

[56] Incenta, *Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability*, September 2021.

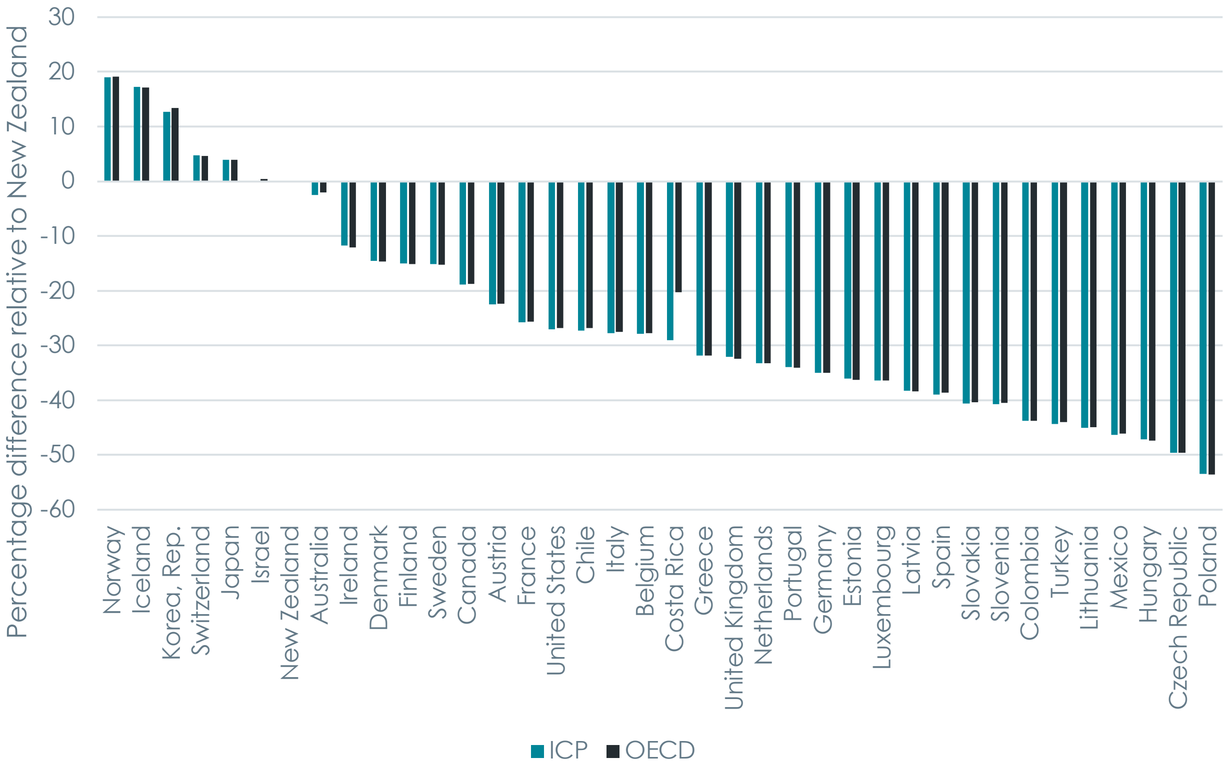
Figure 4.1: Differences in food, beverages and tobacco prices relative to New Zealand




*Source: Reproduction of figure 3.6 from the Commission's draft report.*

78. In figure 4.2, we show that the Commission's analysis remains almost unchanged if the average price of New Zealand's groceries was reduced by two per cent, ie, the amount that would bring the ROACE for FSNI and FSNI approximately into line with the mid-point of Commission's contention as to the estimated WACC, ie, 5.3 per cent. In particular, with this hypothetical adjustment, the level of grocery prices in New Zealand would be ranked seventh, instead of sixth, out of 38 countries.

Figure 4.2: Difference in food, beverages and tobacco prices relative to New Zealand, applying a two per cent reduction in New Zealand prices




*Sources: HoustonKemp analysis of OECD and ICP data.*

79. The analysis we present above shows that the ranking of New Zealand's grocery prices barely changes when prices are reduced to the extent that, as contended by the Commission, FSNI and FSSI would be earning returns that are approximately consistent with their cost of capital.

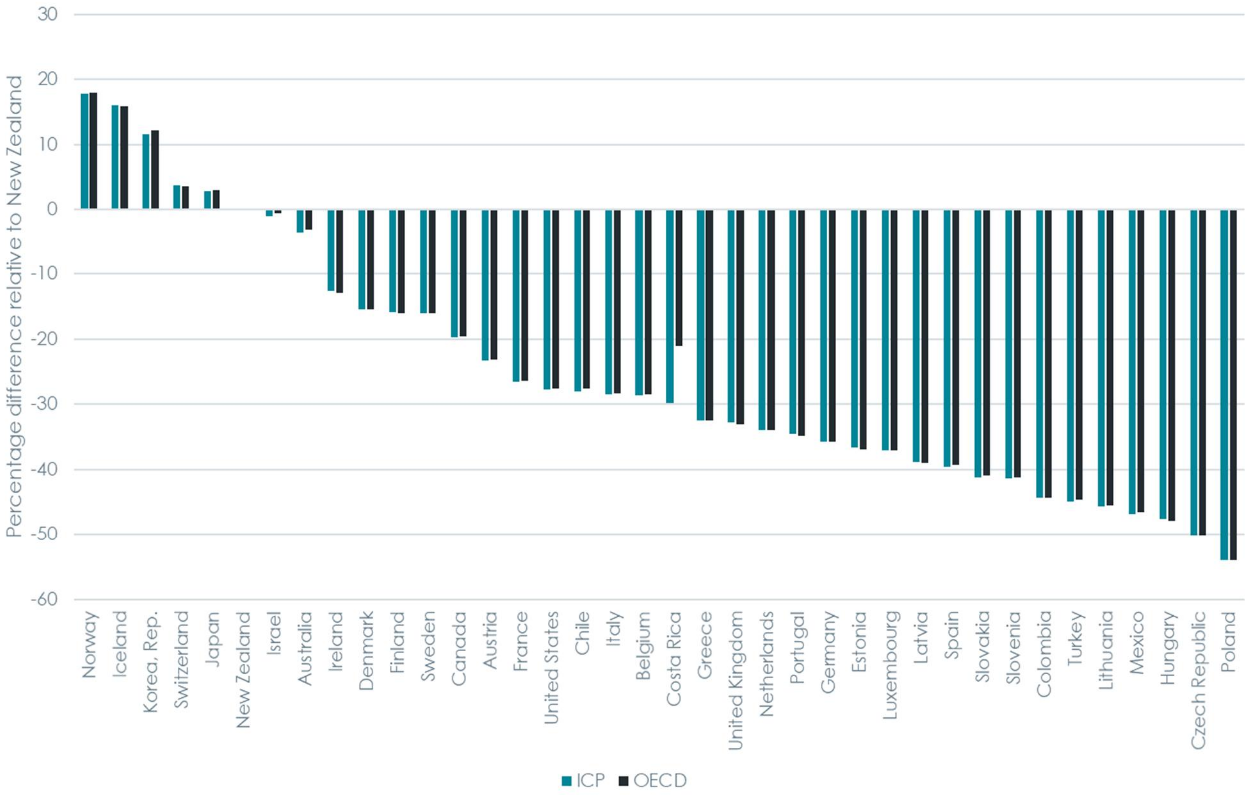
80. It follows that New Zealand's grocery price ranking cannot be explained to any meaningful extent by the nature or effectiveness of competition in the grocery sector and its potential effects on the major grocery retailers' profitability.

81. Put another way, even if the Commission's analysis of profitability in the grocery sector was valid and soundly based – which separate analysis strongly suggests it is not[57] – and even if the recommendations canvassed by the Commission reduced profits such that the return on capital was the same as the cost of capital, no material change could be expected in New Zealand's international ranking of grocery prices.

82. In Figure 4.3 we show that the results of the Commission's international comparison of grocery prices would not change at all if prices in New Zealand were to fall by the alternative hypothetical of one per cent, ie, a reduction, but not to the full extent necessary to bring returns for FSNI and FSSI approximately into line with the mid-point of the Commission's contended cost of capital. In this scenario, and adopting the Commission's preferred analysis, New Zealand's international grocery price ranking would remain sixth out of 38 countries.

[57] Incenta, *Review of grocery retailing: Comment on the Commerce Commission's analysis of profitability*, September 2021.

Figure 4.3: Differences in food, beverages and tobacco prices relative to New Zealand, applying a one per cent reduction in New Zealand prices




*Sources: HoustonKemp analysis of OECD and ICP data.*

83. The analysis we present above demonstrates that any hypothetical change in the level of grocery prices that would be necessary to bring prices in line with the reasonable level of profits implied by the Commission's contended cost of capital makes no meaningful difference to New Zealand's international grocery price ranking.

84. It follows that the outcomes of the Commission's international ranking of grocery prices are not the result of profits being above any reasonable level and cannot be drawn upon to conclude that competition in the retail grocery sector is not effective. It must be that other factors are principally responsible for the international price ranking conclusions drawn by the Commission.

# A1. Appendix – international price comparisons using PPP

85. Our comparison of grocery prices in OECD countries using the PPP approach for 2017 was undertaking as follows:

    a. we calculated a market exchange rate in United States dollars (USD) by dividing the total nominal expenditure in local currency[58] (ie, the gross domestic product) for each OECD country in 2017 by the total nominal expenditure (ie, the gross domestic product) of that country in USD in 2017;[59]

    b. we calculated PPP ratios for each country in 2017 relative to the United States (US) by dividing the OECD's PPPs relative to the US[60] by the market exchange rate we calculated in the previous step; and

    c. we calculated PPP price levels for food and non-alcoholic beverages relative to the US for each country in 2017 by dividing the OECD's national price level index for food and non-alcoholic beverages[61] by the PPP ratios for GDP we calculated in the previous step.

86. We normalised the PPP price levels relative to New Zealand by dividing the PPP price level of each country by New Zealand's PPP price level and multiplying by 100. We found the difference in PPP price level relative to New Zealand by subtracting 100 from the PPP price level relative to New Zealand. These differences are set out in figure 3.1.

87. The process set out above was repeated with the ICP dataset.[62] We obtained the ICP data by selecting the 38 OECD countries, the series GDP and food and non-alcoholic beverages, and the year 2017. The tables used from the ICP dataset have the following classifications:

    a. expenditure (local currency units, billions);

    b. expenditure (market exchange rate-based, US$ billons);

    c. purchasing power parity (PPP) (US$ = 1); and

    d. price level index (world = 100).

[58] This is 'Table 1.1: Nominal expenditure in national currency (millions)', available at https://stats.oecd.org/Index.aspx?DataSetCode=PPP2017#, accessed 25 August 2021.

[59] This is 'Table 1.3: Nominal expenditure in US dollars (millions)', available at https://stats.oecd.org/Index.aspx?DataSetCode=PPP2017#, accessed 25 August 2021.

[60] These are given in 'Table 1.12: Purchasing Power Parities (USA=1), available at https://stats.oecd.org/Index.aspx?DataSetCode=PPP2017#, accessed 25 August 2021.

[61] These are given in 'Table 1.11: Price level indices (OECD=100), available at https://stats.oecd.org/Index.aspx?DataSetCode=PPP2017#, accessed 25 August 2021.

[62] See: https://databank.worldbank.org/source/icp-2017#, accessed 25 August 2021.

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