

## The Warehouse Group Cross-Submission on Foodstuffs merger

1. The Warehouse Group (**TWG**) provides this cross-submission on the **Proposed Merger** between Foodstuffs North Island and Foodstuffs South Island (together the **Parties**), because it is concerned that the Proposed Merger, if it were to proceed, will in time be shown not to be in the interests of achieving affordable grocery outcomes for consumers in Aotearoa New Zealand. To the extent our participation in this process can help the Commerce Commission (**Commission**) make the best decision on the evidence available, TWG will assist to the best of its ability.
2. As outlined in TWG's original submission dated 9 February 2024, TWG has serious concerns that the Proposed Merger will accentuate the competition issues identified by the Commission in the Market Study into the Retail Grocery Sector (**Market Study**) and make it harder to achieve genuine price competition that results in lower everyday grocery prices to consumers.
3. Since TWG's original submission the Commission has released the Statement of Issues (**Sol**) on 4 April 2024 and the Parties have responded to the Sol on 26 April 2024 (**Parties' Response**) and provided an updated report from HoustonKemp in support (**HoustonKemp Response**).
4. TWG remains concerned about the key competition issues identified in its original submission. 'The Parties' Response is full of assertions about a lack of competitive effects but does not adequately engage on some of the key issues identified by the Commission in its Sol. TWG cannot see how the Commission can be satisfied based on the material provided by the Parties that there is not a real chance of a substantial lessening of competition arising as a result of the Proposed Merger.
5. TWG is particularly concerned that the Commission is being encouraged to step back from a real world assessment of the likely negative impact of the Proposed Merger on suppliers and customers, by engaging more technical arguments about transfer of surpluses and narrow market definitions, and the Parties' general approach to minimisation of the impacts, often by reference to small changes to what is already an extremely poor state of competition in the status quo and factual.
6. The key real world considerations that TWG is concerned not to be lost sight of in the context of the Market Study and current markets structure include:
  - (a) The major grocery retailers, including the Parties, were found in the Market Study to be making excessive profits, yet the Market Study noted no material entry and expansion had occurred. Since the Market Study, there has been more exit. If the market were competitive then those profits would have attracted entry and expansion, particularly with the legislative reform that followed the Market Study. TWG's results reveal how hard expansion is in reality. Any other potential scale entrant would likely also be discouraged by the challenges that an established scale retailer such as TWG is having. Structural change that exacerbates market dynamics that limit profitable expansion, inevitably has a real chance of substantially lessening competition.
  - (b) The Parties' own economic report concludes that the merger will improve the bargaining position of the merged entity relative to large and small national suppliers to the Parties.<sup>1</sup> No evidence was provided of the volume and value that

<sup>1</sup> HoustonKemp Response at [8(a)]



national suppliers represent, but TWG expects that a large proportion of suppliers to the Parties actually supply on a national basis or have the capacity to do so. The HoustonKemp Response appears to acknowledge that all of these suppliers are likely to be detrimentally affected by the Proposed Merger.<sup>2</sup>

- (c) The suggestion that the Commission ought not to be concerned about a structural change to market that the Parties' economic report describes as a shift of surplus from those national suppliers to the Parties, is indicative of TWG's concern about the Parties' motivations and the likely outcome of the Proposed Merger. Describing the transfer of surplus from suppliers to the Parties as a "mere" transfer ignores the real world implication of that effect.
  - (d) Significantly, the transfer of surplus away from suppliers logically impacts the "waterbed effect" identified by the Commission.<sup>3</sup> HoustonKemp's suggestion of an "anti-waterbed effect" in this context is in TWG's respectful view, academic, and removed from the facts. In reality, as TWG has experienced first hand in the situation it faced with Sanitarium, when national suppliers are bound by onerous terms (likely including best price clauses) in arrangements with the major retailers, and have promotional terms that extract the maximum available surplus for the benefit of the major retailers, the national suppliers do not have the available margin that might otherwise be used to offer competing retailers better pricing and terms. In this situation the suppliers default to offering worse terms to competing retailers - or refusing to supply them at all when supply becomes constrained.
  - (e) Finally, when considering the market definition discussion in the Sol, it is important to recall that the Parties do not sell grocery items at retail, the Parties' Franchisees do. The importance of this, is that, as the Commission identifies, bypassing the central buying team at head office is unique to the Parties' grocery operations, and a key way that suppliers bring new products to market. To the extent that one of the expected outcomes of the Proposed Merger is to centralise, or "bring into line" the purchasing by Franchisees<sup>4</sup> (as FSNI has done more successfully than FSSI to date), that avenue for product innovation and market testing will be lost, as will the ability to compare between the two franchise groups the benefits of more, or less, alignment by Franchisees with head office buying approaches. In any event, HoustonKemp's assertion that procurement by individual stores would be unaffected by the Proposed Merger does not appear to be based on a real world assessment of the likely outcomes of the merger, calling into question also its conclusions based on that assumption.<sup>5</sup> As the Commission identified, the ability to introduce new products through store level buying has real implications for welfare enhancing innovation.
7. In the face of the real world reservation about the extent to which the Proposed Merger could or would in any respect benefit consumers, TWG cannot see how the Commission can be satisfied, in the sense that it is not in doubt, that the net effect of the Proposed Merger is not to substantially lessen competition in the affected markets.

### **The Proposed Transaction cannot be expected to benefit consumers**

8. The Parties argue that enhanced buyer power is not a reason to decline to clear the merger because a buyer's ability to achieve lower prices is not in and of itself a lessening of

<sup>2</sup> HoustonKemp Response at [8(a)]

<sup>3</sup> Sol at [159]

<sup>4</sup> Sol at [115 - 116]

<sup>5</sup> HoustonKemp Response at [8(c)]



- competition, because if that results in cheaper products for consumers, it is pro-competitive.<sup>6</sup>
9. As TWG expressed in its original submission, despite claims from the Merging Parties that the rationale for the Proposed Merger is to generate cost efficiencies which will be passed on, there is no evidence that there will be any such pass through of savings to consumers.<sup>7</sup>
  10. The Commission in the Sol stated it was still considering the extent to which any benefits or efficiency gains would be passed on, and the extent to which the previous North Island merger resulted in efficiencies that were passed through to consumers.<sup>8</sup> The Commission has heard from industry participants who consider the North Island Foodstuffs merger led to increased margin for the merging parties, a reduction of suppliers entering the market and did not result in the lower prices promised at the outset.<sup>9</sup> This is of course also the predicted outcome of the Proposed Merger.
  11. Although in a clearance application the Parties do not need to show public benefits that outweigh any lessening of competition, only that the merger does not have the net effect of substantially lessening competition, consideration of the likely consumer outcomes does inform the investigation and analysis of competitive effects. HoustonKemp, in support of its position that although the effect of the merger may be to shift economic surplus from suppliers to the Parties, observes that there is no “correct” apportionment of joint surplus.<sup>10</sup> It also refers to economics literature not recognising an “imbalance” in bargaining power.<sup>11</sup> In these observations it encourages a technical economic approach that is agnostic to the distributive outcomes of the merger. As the Court of Appeal discussed in *NZME & Ors v CC* [2018] NZCA 389, the merger control assessment under the Commerce Act can reflect distributive considerations, on the basis the Commerce Act “reflects the norms of the community it serves”.<sup>12</sup>
  12. While that discussion was in the context of an authorisation decision, as applied in this context TWG encourages the Commission to reflect on whether it is consistent with the wider Commerce Act framework and objectives to allow itself to be boxed into the suggested “bargaining framework” or “monopsony power” dichotomy, when on any analysis, if there is an enhancement of bargaining power through a structural change to a market that shifts surplus from suppliers to buyers, that looks like an enhancement of market power, which is conventionally also framed as a lessening of competition. Where that shift arises in respect of a large proportion of suppliers (eg all national suppliers) then it is difficult to see how the Commission can exclude a real chance of that lessening of competition being substantial.
  13. At a practical level, the Parties have also not provided sufficient evidence to support the proposition that the expected benefits from the Proposed Merger will be passed onto consumers. The Parties have stated that the merged entity would face competitive and regulatory pressure to pass on cost savings;<sup>13</sup> in TWG’s submission this does not reflect the reality of the grocery market for the following reasons:

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<sup>6</sup> Parties Response to Sol at [70].

<sup>7</sup> The Warehouse Group Submission on Foodstuffs merger 9 February 2024 (**TWG Submission**) at [6] - [7] and at [31] - [36].

<sup>8</sup> Sol at [111].

<sup>9</sup> Sol at [113].

<sup>10</sup> HoustonKemp Response at [14]

<sup>11</sup> HoustonKemp Response at [15]

<sup>12</sup> *NZME & Ors v CC* [2018] NZCA 389 at [45]

<sup>13</sup> FSNI and FSSI Response to Statement of Issues 26 April 2024 (**Parties Response**) at [93].



- (a) The Commission identified in the Market Study that competition is not working well for consumers in the retail grocery sector, and that if competition was more effective, the major grocery retailers would face stronger pressure to deliver the right prices, quality and range to consumers.<sup>14</sup> The Parties have not explained how, in that weak (and since then, reduced) competitive environment, competition will ensure pass through of these efficiencies to consumers.
- (b) As TWG has explained in its original submission, reliance on the Commission to deliver outcomes for consumers via regulation is not an answer.
- (i) First, there is an information asymmetry between the Commission and the Parties/suppliers which, even with the whistleblower tool, appears difficult to bridge. This means that enforcement will necessarily be delayed and sporadic and/or inconsistent.
- (ii) Secondly, even with sufficient information, the Commission's enforcement resources, and those of the Courts, are constrained and come at a material cost to society. It is difficult to understand why private gains to the Parties, should come at that public cost.
- (iii) Third, despite the assertions of the Parties in the Response, the evidence to date appears to be that the threat of regulation is not effective. TWG encourages the Commission to test this assertion by inquiring into the process that was required to be undertaken in advance of the Code of Conduct becoming compulsory. TWG understands that compliance with that compulsory code could not be described as comprehensive and complete in respect of all supply arrangements, even now.
14. The Parties assert that they have a strong track record of passing on cost savings to consumers.<sup>15</sup> This was not the conclusion in the Market Study Report. Moreover, as explained in TWG's original submission, the fact the promised benefits to consumers of the previous Foodstuffs Auckland/Wellington merger have not been mentioned in the merger application, and the reality that many of the claims of the benefits that consumers would gain from the merger were not fully realised, raises significant concern as to the accuracy of the Parties' statement that it can be expected to pass on such benefits this time.<sup>16</sup>
15. The Parties track record provides at least a strong basis for the Commission to doubt that the relevant efficiencies will be realised and passed on to consumers.
- The Merged Entity's ability to unilaterally exercise buyer power to extract more favourable terms from suppliers.**
16. In the Sol the Commission notes that it is not currently satisfied the Proposed Merger would not substantially lessen competition due to unilateral effects in markets for the acquisition of groceries, based on the current view that the merged entity may be able to unilaterally extract more favourable terms from suppliers due to an increase in its bargaining power relative to suppliers.<sup>17</sup> TWG agrees that this remains a concern.

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<sup>14</sup> Market study into the retail grocery sector Final report - Executive summary at [page 2].

<sup>15</sup> Parties Response to Sol at [95].

<sup>16</sup> TWG Submission at [31] - [36].

<sup>17</sup> Sol at [81].



17. The Parties have attempted to argue that the Proposed Merger will not meaningfully impact suppliers. The HoustonKemp Response asserts that suppliers typically appear to have realistic options beyond simply supplying to major grocery retailers.<sup>18</sup>
18. TWG does not consider that the arguments made by the Parties adequately address the concerns identified in the Sol:
- (a) As TWG has previously submitted, it is inevitable that the bargaining power of suppliers, when faced with a request for a single national supply contract post-merger, would be materially reduced when compared to suppliers facing a similar request today from two separate entities with separate supply arrangements.<sup>19</sup>
  - (b) It is unrealistic to suggest that many suppliers will have options beyond simply supplying to major grocery retailers; the retailers outside of the duopoly are of an entirely different scope and scale to the major retailers, and do not provide a true alternative for suppliers.
  - (c) It is inconsistent for the Parties to argue that on the one hand, there will be limited impact on suppliers, but on the other hand customers will benefit from lower prices achieved through cheaper supply. In TWG's view, neither is true.
  - (d) TWG also agrees with the Commission's concern expressed in the Sol that increase buyer power of the Merged Parties could lead to a 'waterbed effect' where suppliers increase their prices, or provide worse terms, for competing retailers.<sup>20</sup> Its own experience in respect of the withdrawal of supply by Sanitarium suggests this is a real concern.

**The Merger is likely to increase barriers to retail entry and expansion.**

19. As previously noted, in TWG's view the Proposed Merger is likely to increase barriers to retail entry and/or expansion at scale.<sup>21</sup>
20. The Commission is considering a number of ways in which the Proposed Merger could increase barriers to entry and/or expansion by third parties in the retail grocery market including through a change in the Parties' buying power in the acquisition of groceries impacting on the ability of rival grocery retailers to acquire groceries on terms which allow them to compete effectively.<sup>22</sup> The Commission has stated the Proposed Merger would change the bargaining position relative to its suppliers which may lead to worse retail consumer outcomes in the long run due to raising the minimum required scale for rival acquirers of groceries to enter and effectively compete in the market.<sup>23</sup>
21. The Parties' response to the Sol states that if the merged entity achieves better terms and offers lower prices to consumers, that is pro-competitive<sup>24</sup> and that if lower prices from the merged entity deterred entry, it would be because prices were too competitive for the to

<sup>18</sup> HoustonKemp Response at [47].

<sup>19</sup> TWG Submission at [19].

<sup>20</sup> Sol at [142].

<sup>21</sup> TWG Submission at [23].

<sup>22</sup> Sol at [55].

<sup>23</sup> Sol at [156].

<sup>24</sup> Parties Response to Sol at [95] at [168.1].





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**Increased risk of coordinated effects**

- 29. TWG agrees with the Commission’s summary in the Sol that there are several factors which could increase the ability and incentive for the merged entity and Woolworths New Zealand to coordinate in the acquisition of grocery products.<sup>28</sup>
- 30. As expressed in our original submission TWG has concerns that the greater symmetry of scale and cost structures between the merged entity and Woolworths New Zealand could increase the risk of coordinated effects.<sup>29</sup> This effect would be exacerbated by the Parties increasing centralisation of Franchisees’ purchasing as a result of the Merger, given the potential disrupting effect that Franchisee divergence from central purchasing decisions would otherwise continue to have on coordination between the major retailers in the counterfactual.

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<sup>28</sup> Sol at [126].

<sup>29</sup> TWG Submission at [20].

