FOODSTUFFS SOUTH ISLAND POST-CONFERENCE SUBMISSION ON THE GROCERY MARKET STUDY DRAFT REPORT

Outline of submission

1 Foodstuffs South Island (**FSSI**) welcomes the opportunity to provide a final submission to assist the Commission to refine its findings, and options for recommendations, for its final report.

2 In this submission, FSSI provides additional information and evidence on points that have been raised since submissions on the draft report. The information and evidence further substantiate that:

2.1 the retail grocery sector is currently **workably competitive**, and will be more so as retailers enter and expand. The level of competition is evidenced by:

(a) most significantly, actual evidence of the **nature of competition** in grocery retail markets. Most consumers purchase their groceries by way of shopping missions, rather than a main shop, and for all of these missions, FSSI faces strong competition from other retailers as well as from Woolworths New Zealand (**WWNZ**). The evidence shows that competition occurs on price, and non-price, dimensions with respect to:

(i) the competitive constraint posed by other retailers, and

(ii) the extent of competition with WWNZ, and

(b) each of the **indicators of competition** that have been considered. Namely:

(i) FSSI's return on capital of 11.5% is consistent with the returns made by the appropriate benchmark of overseas supermarkets – the average ROACE of the Commission's international sample of grocery retailers is 11.3%,

(ii) international price comparisons say little about the actual level of competition but, in any event, New Zealand ranks 21st in the OECD on a purchasing power parity (**PPP**) basis,

(iii) FSSI is an innovative business and is continually responding to competitive pressure to innovate. FSSI has most of the international innovations that the Commission cites in the draft report, and

(iv) FSSI competes strongly on the quality, range and service aspects of the retail grocery offer with many players, and

2.2 other than the barriers imposed by regulatory requirements including planning law, there are **no material barriers to entry or expansion** for competitors catering for a range of shopping missions, operating different business models, and competing across the PQRS spectrum. The lack of barriers to entry and expansion is borne out by the entry and expansion that have occurred, or been announced, including during the course of this study (and is also consistent with the competition indicators). As to specific potential barriers noted during the process to date:

(a) scale is not a pre-requisite for competing with the major grocery retailers, and this is borne out by FSSI's experience daily,

(b) access to supply chain infrastructure is readily available from third party providers,

(c) there do not appear to be any difficulties with obtaining capital, including both domestic and overseas capital, and

(d) relationships with suppliers can be comprehensively established in a short period, and

2.3 the market for the acquisition of groceries by retailers is **workably competitive** and the potential concerns expressed to the Commission by some suppliers and their representatives in the course of the study would be comprehensively addressed by the introduction of a grocery code for the industry.

3 The evidence that has been presented during the process to date has implications for the Commission's draft **options for recommendations**. That is:

3.1 the options that FSSI has agreed to are comprehensive of the changes that can be supported by the evidence, and will:

(a) deliver value to consumers by improving their ability to make informed shopping decisions,

(b) improve outcomes for suppliers and customers by working with suppliers and the Government to develop a grocery code for the industry, and

(c) encourage competition and remove barriers for new entry and expansion by ending the use of restrictive land covenants and exclusivity provisions in leases,

3.2 despite a lack of evidence that it is necessary, FSSI is exploring how it could put together a commercially attractive offer to **supply products** to other retailers, in case this would give rise to potential net benefits for grocery market competition. FSSI believes that, if such net benefits are established, additional access to suppliers' products through FSSI is achievable on a voluntary basis – regulated access would be complex and difficult as well as being unwarranted in a context where there would be several competing suppliers, and

3.3 **other options for recommendations** put forward by the Commission in the draft report, and raised by other submitters, are not justified based on the evidence that has been presented during the process, and is presented in this final submission. They would also not be likely to improve outcomes for consumers. Those options are:

(a) forced divestment of some of the major retailers' owner-operator retail stores, supply chain assets, or a combination of both,

(b) government facilitating new entry – FSSI provides comments to assist consideration of this option while noting that it is a matter for the government whether to become involved in grocery retailing, and

(c) authorising suppliers to bargain collectively with retailers (outside of the current collaborative activities exception).

4 FSSI provides the following reports with this submission:

4.1 Incenta Consulting – Measuring profitability for the grocery retailers: matters arising from the conference,

4.2 HoustonKemp – Empirical evidence of grocery sector competition – further analysis,

4.3 HoustonKemp – International comparison of grocery prices – further report, and

4.4 HoustonKemp – Private label products in retail grocery markets.

5 The points set out in this submission are not comprehensive of FSSI's response to the market study, so it should be read in conjunction with FSSI's previous submissions. Rather, in each of the following sections, we focus on responding to the key points that emerged from the Commission's conference, and providing additional information and evidence that have emerged, or that respond to points made, since the draft report.

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THE NATURE OF COMPETITION IN THE RETAIL GROCERY SECTOR

FSSI's response to the discussion at the conference, and overview of this section

6 FSSI understands the Commission accepts that:

6.1 most consumers purchase their groceries by way of shopping missions rather than a main shop, and that major grocery retailers are unable to price discriminate with respect to consumers who are carrying out a main shop, and

6.2 as such, there is no "market power" associated with the main shop that can be exploited, and grocery retailing is potentially contestable by a range of market participants.

7 But, from comments made at the conference, the Commission appears to consider that, in practice, this potential contestability has not resulted in material competition emerging. The Commission considered this was borne out by market share data, with the Commission's analysis in the draft report showing that the major retailers have a combined share of between 70 and 90%.[1]

The Commission's market share analysis does not present an accurate picture

8 In the conference, the Commission placed emphasis on high and stable market shares as evidence of a lack of competition.[2]

9 FSSI does not dispute that the major grocery retailers supply a material share of retail grocery products in New Zealand. But the Commission's assessment of market shares tends to overstate the major grocery retailers' combined share, because the Commission did not include the full range of retailers with which the major retailers compete (evidence of the extent of this constraint is set out below from paragraph 17).

10 The Commission presented three different analyses of market shares in the draft report:

10.1 adopting the major retailers' estimate of market shares, which the Commission said showed a combined share of 80-90%,

10.2 estimating market share using sales revenue data sourced from financial and management accounts of the major grocery retailers and a sample of other grocery retailers. This estimate showed a combined share of close to 100%, and

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[1] Dr Small (Commissioner) at lines 1-6, page 15 and lines 16-27, page 16 of the transcript from the Retail Grocery Market Study Conference, Day 1 (21 October 2021).

[2] Day 1, page 15 lines 1-6, "…the market share information which, by our estimates and also by the majors' estimates, seems to be reasonably stable between the two large networks at over 80%. So pretty large and pretty stable over time. We're having trouble reconciling that with the submissions that say that there's increase in competition for non-main shops and that those non-main shops are of an increasing importance."

10.3 estimating market share using data obtained from Statistics NZ on the total size of the groceries and supermarkets sector. This estimate resulted in a combined share of between 70-80%.

11 In addition, the Commission noted Canstar's "independent assessment" of a combined market share of 85% in 2020.[3] The Commission cited a Stuff.co.nz article as the basis for Canstar's estimate.[4] This article notes that Foodstuffs has a 53% share of the grocery market and Countdown has a 32.4% share, but otherwise provides no detail of how that share was calculated, or what retailers were included in the analysis. FSSI is therefore not able to comment further on that estimate.

12 None of the market share estimates in the draft report includes the full range of other grocery retailers that FSSI competes with day-to-day. Retailers omitted from some or all of the market shares analysis, but with which FSSI competes, include:

12.1 specialist grocery retailers i.e. butchers, fish mongers, greengrocers and farmers' markets and bakeries,

12.2 regional competitors and individual store competitors,

12.3 liquor stores,

12.4 petrol stations with a convenience offering,

12.5 non-food grocery retailers i.e. The Warehouse, Chemist Warehouse, Kmart, Briscoes, Mitre 10, health stores, pet stores and others. There is a tendency to overlook that supermarkets include a large number of non-food items. FSSI estimates that FSSI competes with a wide range of other retailers for these sales. However, no non-food only grocery retailers were included in any of the market share analyses,

12.6 suppliers operating direct to consumer platforms such Ecostore and Café L'Affare,

12.7 other e-commerce only competitors, such as meal kit providers, and e-commerce platforms like pet.co.nz and nappies.co.nz, and

12.8 any out of home consumption i.e. restaurants, cafes and takeaway, including UberEats. Again, FSSI considers that it competes for customers in an overall market food and groceries (i.e., share of stomach). For example, consumers may choose to cook a given meal from scratch, or eat out, or order takeaways.

13 Finally, the extent of other retailers' share in the overall market for food and groceries can be observed from the increase in sales FSSI experienced during the COVID-19 lockdowns. While the initial large increase in sales most likely reflects some panic buying, the persistent increase in sales above normal levels reflects the food and grocery spend that is being diverted from other retailers, which are not allowed to operate during lockdowns, to supermarkets. FSSI's data shows that sales at its stores increased by [REDACTED] during 30 March to 3 May 2020, compared to

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[3] Draft report at [5.80.3] and [5.85].

[4] Footnote 292.

1 April to 5 May 2019, and that these sales were diverted from Out of Home consumption and liquor. FSSI considers it competes for each of these categories, to at least some extent.

Market shares have little to say about the nature of competition, in and of themselves

14 The Commission appears to place significant weight on the market shares analysis as demonstrating that the major retailers are not constrained by other retailers. However, a market share analysis is not conclusive evidence of competitive constraints. In particular, as the Commission acknowledges in the draft report, high market shares alone do not necessarily mean a firm has market power.[5] This conclusion is also supported by:

14.1 the Commission's Merger and Acquisitions Guidelines, which includes the following statements:[6]

> Market share and concentration measures, and changes in market share or concentration resulting from a merger, can indicate the extent to which firms in a market are subject to competitive constraints, and the extent to which those constraints might change as a result of a merger...
>
> However, in all cases, market share measures are insufficient in themselves to establish whether a merger is likely to have the effect of substantially lessening competition...
>
> We use market share and concentration indicators to identify mergers which are less likely to raise competition concerns. These indicators are intended to provide an initial guide to merging firms, but are not a substitute for full competition analysis.

14.2 the ACCC Merger Guidelines, which similarly does not treat market share as determinative, noting:[7]

> It is the link between concentration and the strength of competition that is important for merger analysis and this ultimately requires consideration of all relevant factors before a final conclusion can be reached.

14.3 Noonan, who states that "simple statistical measures of concentration will rarely provide a complete picture of the competitive conditions in a market".[8]

15 As such, the major retailers' high combined market share is not in and of itself decisive evidence that the major retailers are unconstrained. It is only one factor to be considered in assessing the state of competition in a market and must then be tested against a detailed competition assessment.

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5 Draft report at [5.78].

6 See also Commerce Commission *Decision No. 448 Progressive Enterprises Limited; Woolworth (New Zealand) Limited* (14 December 2001) at [110]; and Commerce Commission *Pact Group Pty Limited and Viscount Plastics (NZ) Limited* [2012] NZCC 11 at [79] for similar comments.

7 ACCC *Merger Guidelines* (November 2008, amended November 2017) at [7.7]–[7.8]. Available at: https://www.accc.gov.au/publications/merger-guidelines.

8 Chris Noonan *Competition Law in New Zealand* (online looseleaf ed, Thomson Reuters) at [14.C.3.2.3].

Evidence of the competitive constraint imposed by other retailers suggest meaningful constraints

16 FSSI does not consider that the market shares meaningfully explain the competitive constraint posed by other retailers. Rather, the constraint can be observed from evidence regarding how FSSI responds to competition, set out below.

Price competition

17 FSSI competes with a range of other retailers on price, as evidenced by FSSI's ongoing and consistent price monitoring of other retailers, and price adjustment in response to that monitoring:

17.1 At an Island level:

(a) FSSI's Category Managers, when setting pricing look at [REDACTED]. This is a key part of the Category Managers' role.

17.2 At a Store Level:

(a) Individual Members compete on price every day in their local catchments. Members regularly monitor the price of other retailers operating in their catchment area. Each Member has the ability to discount prices below the island-wide RRP in response to competition. Members also give feedback on prices to the Category Managers. This provides another mechanism to ensure price competition from other retailers, even those operating in a particular catchment, is taken into account in FSSI's island-wide pricing.

QRS competition

18 Other retailers exert a competitive constraint on FSSI's quality, range and service offering. The Commission noted in the draft report that it had not seen "any consistent evidence of [the major retailers] adjusting their product and service offerings in response to competition from other retailers".[9] FSSI disagrees with this statement. Examples of FSSI adjusting its quality, range or service offering in response to competition from other retailers are set out below.

19 In terms of <u>quality</u>:

19.1 [REDACTED].

20 In terms of <u>range</u>:

20.1 FSSI developed, trialled and refined meal kits – a new product offering – in response to the entry of meal kit providers. Meal Kit providers are growing market share and are a significant competitor. As such they exert a real constraint and have stimulated real changes in FSSI's conduct. FSSI now offers meal kits at New World and Four Square, ("Simply Dinner") and PAK'nSAVE ("What's for Dinner?") across the South Island,

20.2 FSSI expanded its meal solutions in response to out of home competitors. This includes a range of options, depending on consumer need, including Ready to Cook (e.g. meal kits, salad kits), Ready to Heat (e.g. made in-store

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[9] Draft report at [5.48]

fresh pizzas, frozen/chilled meals) and Ready to Eat options (e.g. pre-prepared deli foods including sandwiches, hot food/meals and rotisserie chickens), and

20.3 FSSI offers in-store dining options, with cafés and other food options,

20.4 FSSI expanded its range in a number of product categories in order to compete with other retailers, including:

(a) personal care: [REDACTED]. In particular, FSSI partnered with Zuru Edge to deliver a controlled label vitamin range, Health by Habit. [REDACTED]. FSSI subsequently partnered with Zuru to deliver another controlled brand in this category, Monday Hair Care. In addition, FSSI ran health and wellness week promotions at PAK'nSAVE and New World, to highlight its product offering, [REDACTED],

(b) health and wellbeing: FSSI expanded its range of health and wellbeing products in response to specialty health food stores. As a part of this, FSSI began stocking a wider range of organic, gluten free and plant based products. FSSI also launched a number of different Pams ranges in this category, including:

(i) Pams Superfoods, which includes health food products like quinoa, goji berries and cacao nibs,[10]

(ii) Pams Organic, with organic fruit, vegetables, meat and dairy products,[11]

(iii) Pams Gluten Free, with biscuits, muesli and baking products,[12]

(iv) Pams Free Range, with free range eggs and chicken products,[13]

20.5 Pams Plant Based, which includes alternative meat products, plant milk and plant based ready meals,[14]

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[10] https://www.pams.co.nz/discover/pams-superfoods

[11] https://www.pams.co.nz/discover/pams-organic

[12] https://www.pams.co.nz/discover/pams-gluten-free

[13] https://www.pams.co.nz/discover/pams-free-range

[14] https://www.pams.co.nz/discover/pams-plant-based

20.6 Pams Finest: FSSI developed the Pams Finest Range to offer gourmet products, featuring high quality natural ingredients and no artificial colours or flavours, and

20.7 bakery products: New World and PAK'nSAVE stores have an extensive bakery offering, with artisan bread and other baked goods, in part to compete with the offering from bakeries and specialist supermarkets,

20.8 in order to compete with bulk/refill stores, FSSI has expanded its traditional bulk foods offering to include refill stations for cleaning products in store, partnering with Ecostore to do this,[15]

21 in terms of <u>service</u>:

21.1 in order to compete on convenience:

(a) FSSI introduced features at its stores to minimise the customer burden of entering a large, full range supermarket through means such as "cut throughs" and self-checkouts, SHOP'nGO to enable convenience based shopping,

(b) FSSI has begun to rollout self-checkouts in some Four Square stores,

21.2 in order to compete with meal kit providers and other retailers, and to respond to customer demand, FSSI introduced a range of recipe builder options, which reduce the burden for customers of having to plan their dinner meals. For example, FSSI:

(a) launched the Recipe of the Week at New World, both in-store and online,

(b) launched the first phase of New World's shoppable recipes on 11 November 2021 (a recipe builder tool), for example:

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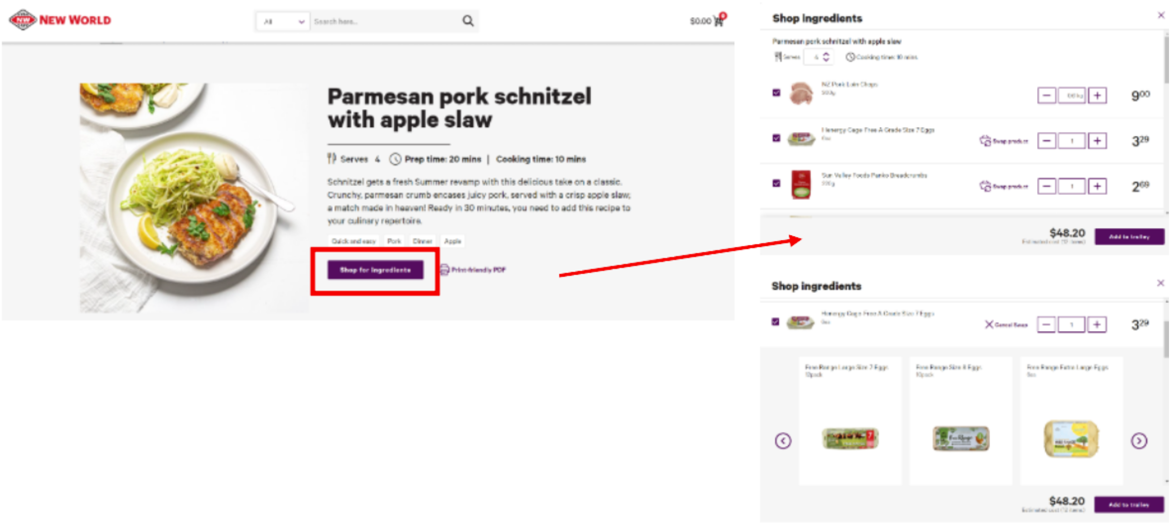
[15] https://www.newworld.co.nz/who-we-are/news/ecostore-refill-stations-at-south-island-stores



21.3 all FSSI New World and PAK'nSAVE stores have butchers (where Countdown does not) to provide high quality cuts of meat and to compete on service dimensions with specialist butchers, and

22 Again, this demonstrates that while other retailers may not have significant market share, or indeed even be included in the Commission's estimate, they nonetheless exert a real competitive constraint on FSSI with real and measurable benefits for consumers.

Competition with WWNZ

23 The Commission tends to comment on FSSI and WWNZ's combined market share, which FSSI considers is not an appropriate lens given there is strong competition between the two.

24 FSSI faces competition from a large multi-national company, which is able to leverage off of its operations in Australia to compete in New Zealand. WWNZ is a very significant competitive constraint. This is illustrated by the degree of cross-shopping between the two major retailers.

25 The evidence supports a conclusion that FSSI and WWNZ compete strongly, for example:

25.1 <u>differentiation of retail banners</u>. Differentiation is pro-competitive. It is a strategy by which FSSI seeks to appeal to different parts of the market, and win customers. Differentiation is not a way to avoid competing, or a strategy to segment the market, contrary to the comments made by Dr Small at Day 1 of the conference. Dr Small queried whether:[16]

> its kind of a market segmentation strategy, you see some people who are willing to pay a bit more for an upmarket type New World experience and others [maybe place] more weight on price and less on some of the other dimensions of your offering and they might tend to favour a PAK'nSAVE?

(a) as the Commission's consumer survey demonstrated, a wide range of factors drive store choice, of which price is just one factor. It is

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[16] Dr Small (Commissioner) at lines 19 to 23, page 38 of the transcript from the Retail Grocery Market Study Conference, Day 1 (21 October 2021).

therefore essential that retailers compete on a mix of price and non-price dimensions in order to win consumers. This is a normal part of the competitive process in grocery retail markets overseas (discussed further below),

(b) just over 15% of respondents in the consumer survey selected "lowest prices overall" as the single most important driver of store choice. Therefore, if the major retailers were to compete with each other solely on price they would not be catering to the majority of consumers. At the simplest level, the fact that some consumers prefer QRS factors in preference to price, is demonstrated by the fact that many consumers choose to shop at Countdown, and New World, in preference to PAK'nSAVE,

(c) FSSI does not consider that the major retailers have effectively segmented the market with differentiated offerings. One way to test this is to ask whether PAK'nSAVE and New World compete day-to-day for Countdown customers, and FSSI considers they undoubtedly do. This competition reflects that there is a significant overlap in the PQRS offering of each of the major supermarkets, meaning that a segmentation strategy is simply not possible. The competition between supermarkets is best reflected by the fact that two thirds of consumers shop between banners in a given month. This means that the major retailers are competing with each other, and there is competition between FSSI's retail banners,

(d) similarly, FSSI does not consider that consumer choice, across all types of mission shopping, between retailers is simply driven by location (or convenience).[17] Cross-shopping may equally be driven by access to higher perceived quality products, or different range e.g., private label products, or access to a weekly promotion,

(e) if the major retailers had effectively segmented the market between them, then there would be no need for the conduct which indicates strong competition between the major retailers – which the Commission identifies (discussed below),

25.2 the major retailers regularly <u>monitor</u> the prices, product and service offerings of competitors in order to remain competitive, and adjust their competitive strategies in response:[18]

(a) the Commission noted that the major retailers "monitor price levels for specific products with the aim of maintaining specified price differentials between the major grocery retailer banners".[19] The Commission said

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17 Dr Small (Commissioner) at lines 32 to 33, page 38 of the transcript from the Retail Grocery Market Study Conference, Day 1 (21 October 2021): "... some of that [cross-shopping] is probably driven by convenience or happen to be different places and for whatever reason...".

18 Draft report at [5.103] and [5.104].

19 Draft report at [5.113].

that this "active management of price differentials may provide a way for the major grocery retailers to avoid direct price competition",[20]

(b) FSSI disagrees that monitoring the prices of WWNZ, with a view of achieving a price differential, is a way of avoiding competition. FSSI considers it is pro-competitive for it to monitor WWNZ's prices – certainly it would be a strong sign of a lack of competition, if FSSI did not monitor WWNZ's prices,

25.3 the major retailers offer <u>promotions</u> frequently, and on a significant proportion of products,[21]

25.4 the major retailers are constrained to <u>pass through their costs</u> in a way that is far from complete or consistent,[22] and

25.5 frequent and high levels of <u>cross-shopping</u> by customers across supermarket banners and retail grocery stores more generally.[23]

National pricing does not necessarily facilitate coordinated conduct

26 During the conference, Commissioner John Small queried whether the national pricing strategies adopted by Foodstuffs and WWNZ may facilitate coordinated pricing conduct.[24] FSSI disagrees that its Island-wide pricing strategy facilitates accommodating conduct. This is consistent with the Commission's finding in the draft report that there was no evidence of such conduct.[25]

27 Further, as explained by HoustonKemp in its report:[26]

27.1 the literature Commissioner Small refers to uses a highly simplified parameterised example, which is difficult to apply to the complexities and uncertainties of the grocery sector in New Zealand in practice, such as extensive cross-shopping and the sheer number of local markets and SKUs,[27]

27.2 retailers with multiple stores may adopt uniform pricing for a variety of reasons other than to engage in coordination, including to minimise costs, increase customer satisfaction, and due to the difficulties of measuring local

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20 Draft report at [5.114].

21 Draft report at [7.52].

22 Draft report at [8.138] and Attachment E.

23 See, for example, FSSI submission on the draft report at [300] and WWNZ submission on the draft report at [29.2.1]; and Mr Gluckman (WWNZ) at lines 25 to 30, page 8 of the transcript from the Retail Grocery Market Study Conference, Day 1 (21 October 2021).

24 Commissioner John Small at lines 28–33, page 36 of the transcript from the Retail Grocery Market Study Conference, Day 1 (21 October 2021).

25 Draft report at [5.158]-[5.161].

26 HoustonKemp Empirical evidence of grocery sector competition – further analysis at section 4.

27 At section 4.1.

demand.[28] Other regulators have accepted that national or uniform pricing can be adopted for reasons other than weakening competition,[29] and

27.3 it is likely to be very difficult to coordinate in the New Zealand retail grocery sector,[30] consistent with the Commission's preliminary findings in the draft report.[31] HoustonKemp demonstrates that it would be difficult for grocery retailers to reach an agreement[32] and monitor compliance with the agreement and punish cheating.[33] In addition, there are a number of other retailers exerting competitive pressure on WWNZ and Foodstuffs, and no material barriers to entry or expansion, undermining the potential profitability of any such coordination.[34]

Stability of market shares does not mean that major retailers are not competing closely

28 The Commission notes that the stability of the major retailers' market share suggests they are not competing closely.[35] FSSI disagrees and notes that statistics on cross-shopping show that there is a large degree of competition between the major retailers. Further, the Commission's reliance on market shares is misplaced, and not supported by the evidence:

28.1 FSSI has already expressed serious reservations about the accuracy of the market share data. However, in any event, Table 5.2 of the draft report (the Stats NZ assessment) demonstrates that the major retailers' combined share varies from one year to the next by approximately three to six percent,[36]

28.2 the market share data, which is presented in a high-level, aggregated way (Island-wide, or national) on an annual basis will mask:[37]

(a) fluctuations in market shares which can vary week from week as retailers monitor sales and the conduct of other competitors on a weekly basis and react quickly. For example, [REDACTED],[38]

(b) variation of market shares because of the exclusion of specialist grocery retailers,[39]

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[28] At section 4.1.2.

[29] At section 4.3.

[30] At section 4.2.

[31] Draft report at [4.35–4.36], [4.55].

[32] HoustonKemp Empirical evidence of grocery sector competition – further analysis at section 4.2.1.

[33] At section 4.2.2.

[34] At section 4.2.3.

[35] Draft report at [5.93].

[36] Draft report at figure 5.2.

[37] See HoustonKemp Empirical evidence of grocery sector competition – further analysis at section 5.

[38] HoustonKemp Empirical evidence of grocery sector competition – further analysis at [292(a)] and [295(b)]; referring to [REDACTED].

[39] At [293].

(c) the extent of cross-shopping between the major retailers. The effect of cross-shopping will be "cancelled out" in market share data to the extent some consumers switch in one direction, and other consumers switch in the opposite direction,[40]

(d) dynamic competition within certain product categories (food and non-food), which each make up a small proportion of a large number of SKUs, and

(e) fluctuation of particular retailers where the market shares of the major retailers and other grocery retailers have been aggregated,[41] and

28.3 instead, the market share data, as discussed above, limited in scope, focuses on the physical stores nationally and there is still a geographic dimension to how customers purchase groceries. As such, the high-level shares do not capture variations in local competition (or the nuances between local and national competition). FSSI notes that local competition is changing generally with the growing presence of online platforms such as Supie.

29 Put another way, summing a large number of random variations in market share at a local level, is likely to give a national figure that does not change very much over time.[42] To more accurately assess whether market shares are stable, the Commission should look at local market shares split by banner.[43] At a regional level, given the data available, HoustonKemp demonstrates that market shares fluctuate weekly for each banner.[44]

30 Aggregating market shares at an island or national level means that some of the variation at a local or regional level is lost.[45]

31 It is also not clear from the draft report what level of stability of market shares would be indicative of a competition problem. Table 5.2 of the draft report demonstrates fluctuations of three to six percent year to year. Further HoustonKemp notes that:[46]

31.1 setting aside competition, market shares may be more stable where:

(a) firms respond quickly to losing market share if a loss of sales has a significant effect on its profits,

(b) firms respond quickly to competitors,

(c) consumer demand is stable, and

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40 At [295(a)].

41 At [295(c)].

42 At section 5.2.

43 At [297].

44 At section 5.2.

45 At [302].

46 At [305].

(d) firms have similar cost bases (i.e. a similar cost of providing a product).[47]

32 Therefore, stable market shares are not in and of themselves indicative of a lack of competition. The Commission has not explored the cause of stable market shares to determine whether it is a problem, such as because of a small proportion of customers switching or accommodating behaviour.

33 Finally, HoustonKemp notes that market shares are stable in other industries and countries. For example, the market shares for groceries in Great Britain have been stable over a similar period to that looked at in the draft report, notwithstanding that there are a much larger number of retailers.[48]

	Jan-17	Jan-18	Jan-19	Jan-20	Jan-21
Tesco	28.1	27.9	27.7	27.3	27.3
Sainsbury's	16.5	16.3	15.9	15.8	15.9
Asda	15.6	15.5	15.3	14.9	14.3
Morrisons	10.9	10.8	10.6	10.3	10.4
Aldi	6.2	7	7.5	7.9	7.4
The Cooperative	6	5.8	5.9	6	6
Lidl	4.5	5	5.3	5.9	6.1
Waitrose	5.3	5.2	5.1	5	5
Iceland	2.3	2.3	2.3	2.3	2.5
Symbols and Independent	1.8	1.6	1.5	1.6	1.7
Other Multiples	2.9	2.7	3.6	1.7	1.8
Ocado				1.4	1.6

Table 1: Market share of grocery stores in Great Britain

Additional information and evidence

34 In the following sections, FSSI provides additional information and evidence on the following topics addressed in the draft report and/or at the conference:

34.1 QRS competition,

[47] At [306].

[48] At [312]; Table 5.1.

34.2 Island-wide pricing, and

34.3 future competitors.

QRS competition is a normal part of the competitive process, and is valued by consumers

35 Competition between all grocery retailers takes place on price and non-price dimensions of the grocery retail offer. A common theme in the draft report is that competition on QRS is somehow less meaningful, or less preferred, than competition on price.[49]

36 FSSI disagrees with this conclusion. In particular, it is clear that consumers place a high value on the non-price dimensions of the retail offer. As such, differentiation on these factors is a sign of workable competition between retailers, and is not less meaningful than price competition.[50]

37 This is consistent with the approach taken by overseas competition authorities when assessing competition in the retail grocery market. For example, the ACCC assessed drivers of store choice via a consumer survey, and used those results to reach a conclusion that non-price dimensions are important to consumers. The survey results in New Zealand and Australia, and corresponding conclusion in these studies, are set out in the table below.

	ACCC	**Commerce Commission**

Survey results	The ACCC's survey asked respondents to identify factors as "very important" when choosing where to shop for groceries. While ~80% of respondents rated price as very important, high proportions of respondents rated other factors as very important:[51]
	• "food quality" – 90%,
	• "store characteristics, cleanliness, layout etc" – close to 80%, and
	• "range of brands", "range of types of products", "availability of favourite brands" and "parking" – between 60-80%.
		One question asked consumers to select from a range of 19 options to reflect why they chose to shop at their main store. Respondents were able to select as many reasons as they felt applied. While 30% of respondents selected "low prices overall" as a reason for choosing their main store:
		• there were other factors that more widely selected than price:
		  ○ "convenient/easy to get to" – nearly 50%,
		  ○ "familiarity with store/service" – 46%, and
		  ○ "easy parking" – 45%, and
		• there were many other factors that were rated similarly to price:
		  ○ "wide choice of products" – 34%,
		  ○ "good value for money" – 30%,
		  ○ "good quality products" – 29%,
		  ○ "good specials" – 29%,

49 For example, the Commission notes that:

- its consumer research shows that many consumers would prefer price competition rather than product and service differentiation (draft report at [3.145]), and
- differentiation of the retail grocery offer between major retailers and other retailers weakens potential competition between them as they compete for consumers on different shopping missions (draft report at [5.59]).

50 See generally HoustonKemp Empirical evidence of grocery sector competition – further analysis at section 2.

51 Australian Competition and Consumer Commission *Report of the ACCC inquiry into the competitiveness of retail process for standard groceries* (July 2008) (**ACCC inquiry**), Chart 4.2.

	ACCC	Commerce Commission
		○ "the store is pleasant to be in" – 28%, and ○ "open at convenient times" – 27%.
Conclusion	The ACCC concluded that competition on non-price dimensions is a significant element of competition in the grocery industry and provided supermarkets with important opportunities to compete.[52] In particular: • specialty stores (butchers, fishmongers, bakeries, greengrocers, produce markets, pharmacies and Asian grocers) tend to compete with the major retailers on quality and service offering. These specialty stores exerted competitive pressure on supermarkets primarily in the fresh category,[53] and • although the major retailers compete on price, much of the competition between them is on non-price aspects of the retail grocery offer. Non-price attributes offer supermarkets some scope to differentiate their offer and influence consumers' decisions about where to shop. This often involves significant investments by supermarkets, which pay particular attention to non-price aspects such as convenience and the freshness of products.[54]	The Commission concluded that respondents consider convenience or price as their main drivers for their choice of main store.[55]

38 As the table demonstrates, the Commission adopted the same methodology in its market study, obtained broadly similar results to those in Australia, but reached a different conclusion. To the contrary, FSSI's view is that the results demonstrate that New Zealand consumers like their overseas counterparts place high value on the wider elements of the retail grocery offer.

39 To take another example, the UK Competition Commission's consumer survey in its 2000 study asked consumers which factors influenced their decision about where to do their main grocery shopping. The survey found that, while 58% of respondents

52 ACCC inquiry at pages 73-74.

53 ACCC inquiry at page 77.

54 ACCC inquiry at pages 72–74.

55 Draft report at [F5.2] and [2.5].

identified prices charged as a factor, other factors were also significant determinants affecting store choice, including:[56]

39.1 within easy and convenient reach of home – 55%,

39.2 a large range of grocery products to choose from – 45%, and

39.3 availability of sufficient car-parking space (38%), products I want always in stock (36%) and flexible opening hours (36%).

40 The UK study concluded that the main factor and "most likely influential determinant of store choice" is the ability to one-stop shop. Prices charged, convenience and a wide range of grocery products were also found to be "relatively significant determinants affecting store choice".[57] The UK Competition Commission adopted a wide range of measurement techniques to identify consumer preferences towards elements of the retail offer, recognising the importance of non-price competition.[58] In its 2008 study, the UK Competition Commission similarly emphasised the importance of PQRS elements on the nature of competition between major retailers.[59]

41 FSSI's view is that the results from the Commission's consumer survey suggest that consumers value QRS factors. Therefore, competition on those factors is important. However, the Commission has concluded the opposite, finding that QRS differentiation is a way to avoid competing and that customers prefer price competition.

42 The Commission has itself previously outlined the importance of non-price competition in the grocery market. In the *Foodstuffs and Woolworths (separately) / Warehouse decision* the Commission took the view that:[60]

> In the case of supermarkets, product range and quality, service levels, store layout and convenience are all important dimensions of competition as well as price. This is illustrated by the applicants operating different types of supermarkets, such as discount and full service stores.

43 As such, FSSI considers it is a normal part of the competitive process for major retailers, and other retailers, to differentiate their retail offering based on non-price dimensions. This differentiation does not reduce competition between retailers – the competition is multi-dimensional.[61] Differentiation on non-price dimensions is a form of a competition, providing consumers with more choice to match their preferences, and which the consumer survey demonstrates is equally important to consumers as price competition, if not more so.

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[56] UK Competition Commission *Supermarkets A report on the supply of groceries from multiple stores in the United Kingdom* (October 2000) (**UK Competition Commission investigation (2000)**) at Appendix 4.2 at [15].

[57] UK Competition Commission investigation (2000) at Appendix 4.2 at [14] and [15].

[58] UK Competition Commission investigation (2000) at [6.121].

[59] UK Competition Commission investigation 2008 at [3.39], [4.16].

[60] Commerce Commission *Foodstuffs (Auckland) Ltd, Foodstuffs (Wellington) Co-operative Society Ltd and Foodstuffs (South Island) Ltd; The Warehouse Group Limited* Decision Nos 606 & 607 (8 June 2007) at [190].

[61] See HoustonKemp Empirical evidence of grocery sector competition – further analysis at section 2.4.

Island-wide Pricing

44 At the Conference the Commission noted the analysis by Frontier Economics that local market concentration, and entry and exit of major supermarkets, had little effect on local prices. FSSI has read, and endorses, FSNI's submissions on the limitations of the Frontier Economics' analysis, drawing on the report prepared by HoustonKemp.

45 Further, FSSI notes that the Frontier Economics analysis is consistent with the fact that the major retailers set prices at an Island-wide level (FSSI, FSNI) or nation-wide level (Countdown), and therefore that price competition tends to mostly take place at national level.

46 FSSI members can and do change prices locally to respond to local competition by discounting products. FSSI understands that these price changes occur daily. FSSI expects that this was not picked up in Frontier's analysis because:

46.1 Frontier excluded all unpackaged and unbranded fruit, vegetables and meat from its analysis. These are key product categories where price competition often takes place, and

46.2 in any event, Frontier tested for price effects across a price index, comprised of thousands of SKUs, which will therefore not be sensitive to strong competition in particular product categories.

47 Finally, we would note Island-wide pricing is pro-competitive. It means that consumers in remote regions, with fewer competitors, benefit from competition in urban areas where there are more competitors. As such consumers in the regions enjoy lower prices than might otherwise be the case.

Successful future competitors are unlikely to look like FSSI

48 It was commented on at the conference (as well as in the draft report) that other retailers need to go "like for like" with the major retailers in order to be able to compete with them, i.e. have bricks-and-mortar stores, with a full range of groceries, and a significant scale or geographic presence. Some of the questions at the conference asked what an "optimal competitor" would look like.[62]

49 In FSSI's view there are many ways to compete with the major retailers and it is no coincidence that the competitors they face today have a wide range of business models. These models reflect the changing nature of the market and consumer demand. For example, main shop online offers, subscription models, meal kits and grocery deliveries.

50 Since our submission on the draft report FSSI expects this trend to continue – as is the case overseas. For example:

50.1 Supie (which has publicly expressed its wish to become a national online retailer)[63], and The Honest Grocer, compete for the main shop with a purely online offer,

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[62] Dr Johnston (Commissioner) at lines 29 to 31, page 24 of the transcript from the Retail Grocery Market Study Conference, Day 6 (1 November 2021).

[63] Ms Balle (Supie) at line 8, page 5 of the transcript from the Retail Grocery Market Study Conference, Day 5 (28 October 2021).

50.2 Costco, which now has a resource consent to develop a store in Christchurch, will compete for different shopping missions, including the main shop, with a very different business model to traditional supermarkets. Costco operates a paid membership model, with a more limited selection of products across a wide range of merchandise categories. Costco has a strong private label presence through its Kirklands brand,

50.3 Circle K will compete for shopping missions with a convenience style offering, with a particular emphasis on ready to eat meals,

50.4 Geezy Go will compete with an online only offer, using dark stores, and with a 20-minute delivery proposition. Geezy Go has started developing its first site in the Auckland CBD, expected to open in January 2022, and has plans to enter in Wellington,[64]

50.5 meal delivery providers, like UberEats, have moved into grocery delivery, and DeliverEasy has noted its intention to also expand into groceries,[65]

50.6 My Food Bag has expanded its offering beyond meal kits to include ready-made meals and grocery items, including fruit boxes, breakfast foods, snacks, bread and meat.[66] The same trend is observable with meal kit providers in oversea markets. For example, Hello Fresh in the United States has begun offering groceries as a part of its service,[67] and

50.7 increasingly suppliers are creating with direct to consumer platforms, such as Ecostore for cleaning products, Heinz Wattie's with "Wattie's Home Packages", Sanford & Sons or Takitimu Seafoods for seafood, Supreme Coffee and Nestle's "Nespresso" for coffee.

51 With the size of the market it is important that the Commission adopts a forward-looking view in its competition analysis, which takes account of these trends, and resists the temptation to focus on what it would take to foster a "clone" of the major grocery retailers.

Conclusion on nature of competition

52 The evidence set out above demonstrates that FSSI faces strong competition across the price and non-price aspects of the retail grocery offer, from WWNZ and a wide range of other retailers. FSSI monitors and responds to that competition. It is clear that the market is not a "duopoly with a fringe", and FSSI does not treat it like one.

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64 https://www.foodticker.co.nz/online-grocer-geezy-go-to-bring-20-minute-delivery-to-nz/

65 https://www.foodticker.co.nz/covid-came-when-the-market-was-starting-to-mature-delivereasy-and-the-rise-and-rise-of-delivery/

66 https://www.nzherald.co.nz/business/my-food-bag-expands-into-groceries-targeting-growth-from-37b-retail-food-sector/UDZ6EOYNJQY6BOFJP2SIDWSGOE/

67 https://www.supermarketnews.com/online-retail/hellofresh-market-debuts-adding-grocery-items-meal-kit-service

INDICATORS OF COMPETITION

FSSI's response to the discussion at the conference

53 During the conference, the Commission noted that:[68]

> So, while we necessarily discuss all of these [indicators] individually and analyse them individually, all of them contribute together to an overall assessment as to whether or not competition is working as effectively as it can and if not, which might be able to be done to improve it. …
>
> But as we have noted in the draft report and others have also commented, there are quite significant challenges in [assessing] whether outcomes are consistent with competitive benchmarks. …
>
> We do not think it's necessary to find conclusively that outcomes are out of line with competitive benchmarks in order to find that a market is not working as well as it could.

54 FSSI agrees that no single indicator is determinative in a competition assessment, that there are challenges with assessing these outcomes, and that profitability should not be treated as a gating or threshold indicator to assess competition in a market.

55 However, unlike the Commission, FSSI believes that in order to find that a market is not working as well, it is necessary to be able to conclude that, cumulatively, the outcomes are "out of line with competitive benchmarks".

56 Taken together, FSSI considers that the indicators of competition, following its submission on the draft report and further submissions below, support a finding this is not the case and therefore there is workable competition.

57 The following section covers the profitability, innovation and QRS indicators as FSSI have further comment to make in that regard.

57.1 in relation to <u>profitability</u>:

(a) FSSI agrees that profitability has a confined value as an indicator of competition, but

(b) it is critical that the Commission assesses profitability accurately, and

(c) FSSI makes a number of additional points on methodology and accuracy in response to the discussion at the conference,

57.2 <u>international price comparisons</u> are fraught with difficulty and in any event, say little about competition. As such, price ought not to be used as an indicator of competition. In any event, New Zealand ranks 21st in the OECD on a PPP basis,

57.3 FSSI is an <u>innovative</u> business and we wish to record further changes since our submission on the draft report, and

[68] Dr Small (Commissioner) at lines 37 to 40, page 3, lines 4 to 6 and lines 13 to 15, page 4 of the transcript from the Retail Grocery Market Study Conference, Day 4 (27 October 2021). [REDACTED].

57.4 FSSI's <u>QRS</u> offering is consistent with workable competition.

Profitability
Introduction

58 [REDACTED]. FSSI considers that profitability is only one indicator of the nature or intensity of competition. The draft report treated profitability as central, or foundational, to its analysis of outcomes in the retail grocery market and influenced the Commission's conclusions on price, innovation and entry and expansion.

58.1 <u>Price</u>: "While a range of other factors may also influence price, **our analysis of profitability** and our analysis of competition later in this report, leads to our preliminary view that a lack of effective competition is contributing to higher grocery prices in New Zealand than we would expect in a workably competitive market."[69]

58.2 <u>Innovation</u>:

(a) "However, while there is innovation in the grocery sector, including by major grocery retailers, it is primarily focussed on range and service rather than price and is in aggregate **insufficient to explain the level of excess returns earned by the major grocery retailers** over a sustained period of time."[70]

(b) "Despite lagging in digital innovation and penetration, Foodstuffs stores are earning **persistently high excess returns**... This indicates that high profits are not acting as a reward for innovation in grocery retailing..."[71]

(c) "Investments aimed at improving the resilience of the grocery supply chains in New Zealand were demonstrated during the COVID-19 pandemic... However, when viewed in the context of other market observations, such as the **persistent high levels of profitability** and pricing levels discussed above, we are not persuaded that consumers are benefitting from these cost-saving investments as would be expected in a workably competitive market."[72]

58.3 <u>Entry and expansion</u>: "The lack of recent and prospective large-scale entry by a supermarket operator despite the **high profitability of the major grocery retailers** may indicate that conditions of entry and expansion limit the scope for competition to work effectively."[73]

59 The Commission will need to reconsider each of these findings, without the starting assumption that excess profitability suggests a certain outcome.

60 It is critical that the Commission calculate profitability correctly. While that is most obviously true with respect to the accuracy of the findings in the market study, it is

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69 Draft report at [3.69].

70 Draft report at [3.141].

71 Draft report at [3.156].

72 Draft report at [3.171]-[3.172].

73 Draft report at [6.26].

also true because of the substantial reputational repercussions for FSSI. The Commission's publication of an inaccurate assessment of profitability in the draft report and at the media conference, and the subsequent apparent reliance placed on that analysis, caused reputational damage to FSSI.

61 FSSI has said in previous submissions, in the conference and in our confidential sessions that the Commission has materially overstated FSSI's profitability as it has:

61.1 artificially separated the business into Retail and Co-operative, and

61.2 ignored the economic value of land and buildings associated with the business, made errors in its calculations and used comparisons to WWNZ and the international companies that are not on a "like for like" basis.

Whole of Business is the only meaningful way to assess FSSI's profitability and compare FSSI to others

62 FSSI maintains that the profitability of its entire business can only be reliably assessed on a whole of business (WOB) basis rather than the artificial separation into retail and Co-operative (wholesale) undertaken by the Commission. There are not distinguishable 'retail' division and 'wholesale' divisions within FSSI that can be neatly separated and assessed as independent entities.

63 FSSI's average five-year ROACE is 11.5% assessed on a WOB basis, which is in line with comparable international companies.[74] FSSI's profitability, assessed on the other profit measures of Gross Profit margin and EBITAR margin, are also in line with the same international companies.[75]

64 The Commission has been overly simplistic in attempting to separately assess FSSI 'retail' profitability in this manner. As has been stated in all submissions and meetings the level of integration between the Co-operative and the retail stores is far more complex than a simple wholesale/retail distinction. The members of the Co-operative as store owners and shareholders, and the Co-operative itself are inexorably intertwined:

64.1 the members fund the Co-operative to provide support services to the membership such as supply chain and product distribution services, IT, training of new members, the creation and maintenance of the banner formats, granting of banner franchises and undertaking of supplier negotiations,

64.2 importantly member funding enables the Co-operative to purchase land, build new stores and maintain the existing land and buildings. These assets are then leased to members. The lease is linked to their membership through their franchise agreement i.e. a member cannot use that lease unless it is to trade under the terms of its franchise agreement, and

64.3 when leaving the Co-operative the assets of the Co-operative (and any present or future gains or losses with regard to the same) funded with the assistance of that member remain with the Co-operative.

[74] FSSI's submissions on the draft report at [49].

[75] FSSI's submissions on the draft report at [67].

65 There is no logical reason to attempt to separate Retail from Co-operative for profitability analysis:

65.1 WOB is how FSSI operates and such an analysis provides the Commission with an objective, robust and verifiable basis for comparison to WWNZ and international companies. All asset values are known and verifiable.

65.2 It is unclear why the Commission has attempted a retail and Co-operative (wholesale) analysis. There is no reason or benefit for the analysis to separate retail from wholesale. It offers no useful insight for any comparison with our New Zealand competitors or the international comparison companies.

65.3 If the Commission can justify the arbitrary separation of the FSSI business, it should be equally applied to WWNZ and the international sample of companies to provide meaningful analysis.

66 It is worth noting that the international companies used for comparison is a sample of vertically integrated supermarket businesses. That is, they are the combination of the retail and wholesale operations of a supermarket operation.

Profitability Comparison of FSSI with WWNZ and International Benchmark Companies

67 When FSSI and WWNZ are compared on the WOB (integrated) basis they will present significantly different ROACEs using the Commission's methodology. The difference on the ROACE of 11.5% for FSSI and 21.6% for WWNZ for essentially the exact same operational model business suggests one of the following:

67.1 WWNZ is twice as profitable as FSSI. Empirically, this seems unlikely, as FSSI and WWNZ appear to operate essentially the same business models, or

67.2 there is a serious flaw in the analysis completed, causing a significant difference in ROACE.

68 Furthermore, WWNZ has not been split into retail and wholesale divisions for analysis. [REDACTED].[76] This raises some material issues for any resulting conclusions and attempted comparisons:

68.1 FSSI also is a fully integrated operation but the Commission has split it into retail and wholesale. As noted above, FSSI considers the Commission's decision to separate its business as entirely artificial.

68.2 For any meaningful comparison with FSSI (if the Commission insists on artificial separation), WWNZ also needs to be artificially split into retail and wholesale to compare "like with like" structures. To not do this makes any comparison of WWNZ to FSSI (and FSNI) as a "retail" supermarkets meaningless.

68.3 It is unclear why the Commission considers it appropriate to distinguish between the returns FSSI's makes on "retail" assets, on the one hand, and

[76] [REDACTED].

"Co-operative" assets on the other hand, yet for WWNZ is content to calculate the return on both categories of assets combined as a single figure.

69 Furthermore, as set out in more detail below, such an analysis cannot form an appropriate basis for the international comparisons the Commission wishes to use.

70 To reconcile the difference in the ROACE of WWNZ and FSSI (on an integrated basis) a critique of the Commission's method of calculation of profitability is necessary. There are two flaws in the analysis:

70.1 as noted above attempting to separate FSSI into artificial retail and Co-operative (wholesale) divisions that do not exist and are a vast oversimplification of a complicated business and cannot be compared to WWNZ, and

70.2 the reluctance of the Commission to recognise the requirements for a like-for-like comparison between calculated returns and a benchmark, in turn requiring either:

(a) assigning a value of the economic rights and obligations deriving from a long-term lease of land and buildings (what FSSI has referred to as the "owner" assumption), or

(b) recognising that leasing is a form of leverage, and so the calculated return for a renter can only be compared to profitability benchmarks that are reflective of the same amount of leverage (i.e., if a "renter" assumption is pursued).

71 The reasonable way to resolve the comparison between companies with different approaches to asset ownership, i.e. ownership vs. leasing, is to recognise the value of the economic rights and obligations deriving from a lease. This has the following benefits for the Commission:

71.1 It is consistent with the fact that the Commission has, in other processes, recognised the economic value of leases.[77]

71.2 Applying this economic principle to WWNZ profitability calculations allows direct meaningful comparison with both FSSI (and FSNI) when they are viewed on a whole of business basis.

71.3 FSSI, FSNI and WWNZ can then all be compared with the international sample. The international sample companies are in general an asset-owning, vertically integrated collection of supermarket companies.

71.4 In summary this means the Commission would have a meaningful "apples vs apples" comparison that it could reasonably make conclusions from.

72 If the Commission persists with artificially separating retail from Co-operative (wholesale), without allocating asset values and not recognising a lease asset, then it must use a credible comparison set of international companies when assessing

[77] Incenta Consulting September 2021 report at [29].

FSSI's level of profitability. Logic would dictate that the international comparison will be:

72.1 retail only supermarkets (without owned warehousing and distribution function). This will be very rare and will likely be unreliable due a small sample size, and

72.2 companies that lease the majority of their supermarkets (as opposed to owning them). This could be achieved by adjusting the international sample to reflect a 30% level of ownership, this would make it consistent with the artificial assessment of FSSI's profitability reported in the Commission's draft report.[78]

73 If this analysis can be completed it is highly likely to show that the ROACE of these comparison companies will be 20%+. Consistent with this, Incenta Consulting calculated that if the international sample was adjusted to reflect a 30% level of ownership, its ROACE would increase to 21.8%.[79] This then would be comparable to the ROACEs that the Commission has calculated for each of FSSI, FSNI and WWNZ (using the current method of the Commissions calculation).

74 Incenta Consulting notes in its report that this outcome is not to be preferred because it is likely that if the Commission produces returns based on a renter assumption they will be misinterpreted. Incenta explains it is unlikely to be well understood that ROACE calculated on a renter assumption – with a high level of leverage – will produce a high return. In other words, it is not well understood that a highly levered return of 25% or more may well be completely consistent with returns that would be expected from an effectively competitive market.[80]

75 To disregard any of the above points will mean that:

75.1 The WWNZ and FSSI comparison is meaningless – WWNZ is assessed as a vertically integrated business and FSSI is assessed purely a standalone retail division, when in substance the businesses are very similar.

75.2 The international sample comparison is meaningless – it is based on vertically integrated asset owners and is being compared to companies that lease its key assets (as the Commission deems a standalone FSSI retail division to be).

75.3 Overall this presents the Commission with a meaningless "apples vs oranges" analysis that cannot be used to draw any useful conclusions.

76 In FSSI's structure the supermarket operators are the owners of the land and building assets through their shareholding in FSSI. For FSSI it is purely a structuring decision that a co-operatively owned legal entity known as FSSI holds the assets. Equally FSSI could have chosen to place the land and buildings with the operator, with those assets being required to be transferred back to the co-operative at the time a store operator ceases to be a member.

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78 This is discussed in FSSI's submissions on the draft report, at [63] and the Incenta Consulting report dated September 2021, at [116].

79 Incenta Consulting report dated September 2021, at [116].

80 Incenta Consulting report dated November 2021, at [19(a)].

77 FSSI chooses to structure its business with supermarket land and building assets held by the centre. The reason for this is it provides benefits to the Co-operative with regard to flexibility, long-term planning and simpler facilitation of members transferring their stores to other members.

78 To highlight the flaw in the Commission's approach the following counterfactual structure could be analysed:

78.1 If FSSI were to restructure and transfer the land and building ownership from the centre to the stores (and therefore eliminate leases) the only difference is that the land and buildings would transfer to the members' financial statements. The Commission would then recognise the land and building assets in the artificial retail division.

78.2 Using this approach, the ROACE of the artificial retail division would be and average of 8.5% from 2015-2019.[81] This is significantly less than the 22.6% that the Commission calculates for the artificial retail division as a "renter".

78.3 The key learning is that materially different ROACEs are calculated – but the business is exactly the same under each scenario. The calculated artificial retail ROACE has significantly reduced with the recognition of the land and building assets – but there would have been no change to the underlying business. The supermarket would not be less than half as profitable as a result. In fact, nothing would change other than the financial statements – but as noted that is a structuring decision. Economically it is the same business.

78.4 The restructure of land and building assets to the retail stores would have downsides for FSSI – such as making it more complex for store owners to progress up the hierarchy of banners/stores – but this "thought experiment" highlights the significant flaws of the Commission's analysis.

79 Finally, Incenta Consulting notes that, to the extent the Commission is applying a "renter" assumption to avoid arriving at a value for land and buildings, and to make forecast of revaluation gains, then this concern is overstated because:[82]

79.1 the Commission has information available on the market value of the co-operative's land and building assets. While there is some imprecision to such valuations, scenarios can be tested, and

79.2 likewise, while Incenta has set out its views regarding the revaluation gains that would be appropriate, the Commission can test scenarios around these assumptions, or use the book value of assets, with no revaluation gains, to provide an upper bound to the returns that could be derived.

The value of the economic rights and obligations captured within a long-term lease

80 As noted above a fundamental issue in the profitability analysis is that the Commission does not accept that the rights captured within a long-term lease amount to a material economic asset. Accepted industry practice is the recognition

81 FSSI's submissions on the draft report at [68].

82 Incenta Consulting report dated November 2021, at [20]-[22].

of the rights and associated obligation conferred by leases as having an economic value that should be captured within firm's balance sheet. The Commission seems to base its unique view on the misdirected assumption that the combination of rights and obligations captured within a long-term lease cannot be expected to have no material net positive value so therefore should not be recognised for the purpose of estimating and comparing return on capital. This is wrong in the context of a long-term supermarket lease for land and buildings.

81 The Commission suggests that it is incorrect to recognise the rights and obligations arising under an irrevocable lease asset, as a lease is a financing arrangement.[83] To use the Commission's logic, it could mean all assets that are purchased utilising debt should not be assigned a value and removed from any ROACE calculation. This poses some questions:

81.1 What is the difference to the economic value of the rights and obligations arising in relation to an asset if it is debt funded, as compared to be being leased (which is purely an alternate funding methodology)?

81.2 If FSSI owns land and buildings that were purchased using debt funding – do they have zero value in a ROACE calculation?

82 The substance of a multi-year lease is that is purely a funding mechanism for the acquisition of rights to use an economic asset.

83 The Commission has also stated the capital value of a lease is only the amount of set-up costs for obtaining the multi-year lease. The Commission seems to be using accounting rules in relation to the capitalisation of set-up costs to justify its position but ignores the widely accepted accounting and economic principle of seeking to distinguish (and record, for accounting purposes) the respective values of the rights and obligations arising under a multi-year irrevocable lease.

83.1 That is, when assets are leased, there are two transactions that are bundled together, namely the right to use an asset, and the financing of that right. If an asset is purchased, the same two transactions occur, with the only difference being that the party from which the asset is purchased and the party from whom finance is obtained are normally different. But whether these steps are bundled does not change their economic character,

83.2 Indeed, the same thought experiment could be run in relation to a transaction whereby an asset was acquired, as well as debt liability that matched the value of the asset. How much would be paid in this case for the combination of the asset and the debt finance? Assuming the interest rate for the debt liability aligned with current market rates, then it is plausible that no payment would be made, just as the case where a long-term lease is acquired (and where the rental matches current market rates).

83.3 In both cases, a valuable asset (ownership or right to use) is acquired and a liability is also accepted. In both cases, the calculation of an unlevered return requires the assets to be recognised in capital employed, and asset costs (depreciation) recognised in the numerator. And, in both cases, if the assets are not included in capital employed, then the return that is calculated is a

[83] Draft report at [C76].

levered return, and needs to be benchmarked against return that levered to the same level (although, as argued above, there are powerful reasons not to benchmark levered returns, including that such returns are almost certain to be misunderstood).

Comparisons to WACC and the NZX50 are not appropriate

84 The Commission has compared FSSI's profitability to the Weighted Average Cost of Capital (**WACC**) and the ROACE of the NZX50. These comparisons are of limited value for the following reasons.

85 In terms of WACC, FSSI considers that a comparison to other real world examples – i.e., the international sample of grocery retailers, is a more appropriate than comparisons to a theoretical and estimated WACC. As FSSI explained in its submissions on the draft report, there are good reasons why FSSI's ROACE, and the ROACE of the international sample, exceed the Commission's estimated WACC.[84] Incenta Consulting explains in its further report that:[85]

85.1 the Commission's WACC only includes assets that are treated as capital for accounting purposes. However, there is an emerging body of thought in financial economics literature that booked assets miss an important component of the assets of modern firms. In particular, balance sheets exclude intangible assets that firms create and add to over time – and that a new entrant will need to replicate – spanning all aspects of organisation capability. Benchmarking against the returns of other grocery retailers is less likely to omit consideration of these intangible assets, and

85.2 a comparison to WACC raises issues with establishing the appropriate benchmark, including what is the relative risk of a grocery retailer and the question of which WACC should be impounded into today's market prices.

86 FSSI considers that comparisons to the NZX50 are not relevant, nor meaningful. As set out in Incenta Consulting's further report:[86]

86.1 benchmarking was very sensitive to how the returns from different sectors were combined (i.e., whether a simple or weighted average should be applied),

86.2 when further analysing the companies that are somewhat relatable to FSSI a fairer and more relevant comparison can be utilised. These sectors – and the simple average of ROACEs achieved over 2015-19 are:

(a) Consumer Discretionary Products (13.6%)

(b) Consumer Staple Products (12.4%, once Fonterra and A2 Milk are excluded)[87]

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84 FSSI's submissions on the draft report at [54]-[56].

85 Incenta Consulting report dated November 2021 at [26]-[28].

86 Incenta Consulting report dated November 2021 at [29].

87 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.

(c) Industrial Services (transport) (11.5%), and

(d) Real Estate (9.3%).

86.3 When compared to FSSI's WOB ROACE of 11.5%, (or 8.5% as an artificial retail division) it again shows that FSSI levels of profitability are normal and in line with appropriate comparators.

86.4 Additionally, it is reasonable to assume that ownership (rather than renting) and standard methods of financing are dominant across the NZX companies, and so the return calculated should be interpreted as an unlevered return. Thus, if the "renter" benchmark were to be applied by the Commission, the NZX return would need to be adjusted upwards to be consistent with the level of leverage implied by the renter assumption.

Profitability Considerations for the Final Report

87 FSSI believes that the only way to accurately calculate its profitability, and meaningfully and reliably compare it to other retailers, is a profitability analysis that treats FSSI as an integrated whole of business operation.

88 This methodology best reflects FSSI's fully integrated grocery retailing business. There is not a distinguishable retail division and wholesale division that can be neatly separated and assessed as pseudo independent entities

89 However, if the Commission continues with artificial separation into retail and wholesale entities FSSI requests that the Commission consider the following questions when completing its profitability analysis:

89.1 What is the reason for FSSI being artificially separated into retail and wholesale divisions?

89.2 What insight is provided by an artificial separation?

89.3 Why are comparisons with (WWNZ and the international sample) not completed on comparable basis?

89.4 Why are FSSI, FSNI and WWNZ compared as a "renter" to the international companies as "owners"

89.5 How does the Commission reconcile the vastly different ROACE outcomes for a "renter" vs "owner" of assets when the underlying business is exactly the same?

89.6 Why does the Commission disagree with and therefore not recognise the concept of recording the value of the economic rights and obligations deriving from a long-term lease when it recognises the economic value of leases for regulated businesses?[88]

90 FSSI acknowledges that the profitability analysis is a difficult task to undertake, particularly for a co-operative structure like Foodstuffs. Setting aside any differences in view on the approach the Commission should adopt, FSSI remains

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[88] See Incenta Consulting report dated September 2021 at [29].

willing and available to be involved in checking the Commission's final calculations for accuracy.

Price

International price comparisons for groceries are difficult

91 In the conference, as well as in the draft report, the Commission acknowledged many of the difficulties of comparing prices internationally in a non-homogenous product market,[89] and in particular that it is "extremely difficult to do well due to a range of challenges and particularly in the grocery sector".[90]

92 FSSI agrees. FSSI is acutely aware of the issues that may arise when carrying out price comparisons, as it regularly carries out price comparison advertising campaigns for PAK'nSAVE. Potential issues include that:

92.1 the products being compared may not be identical, or even substitutable, as there are a number of dimensions to a grocery product including:

(a) pack size,

(b) quality,

(c) nutritional value,

(d) brand value,

(e) packaging, and

(f) sustainability considerations, and

92.2 comparing a "basket" of products that are not identical can materially skew the results of a grocery price comparison.

93 Further, the ICP data that the Commission has used, does not compare prices of like-for-like "baskets". In particular, the ICP requires countries to collect prices on a range of products that the country deems "representative" or "important" and "less important", with "representative" or "important" products given a higher weighting to calculate average price than products deemed "less important". However, it is likely that the "importance" of grocery products will differ from country to country – what is important in New Zealand, may not be important in the Commission's close comparator countries, including Finland, Iceland and Israel. This means the average prices reported in the ICP data are not made on a like-for-like basis.[91]

94 The comparison of average prices also does not capture the range of prices available to consumer in an environment where competition takes place across the PQRS spectrum. For example, given the methodology by which average prices are derived, new entry by a new high-price, high-service (or a new low-price, low-service) supermarket would increase (or decrease) average prices paid as

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[89] Draft report at [3.86].

[90] Dr Small (Commissioner) at lines 15 to 17, page 5 of the transcript from the Retail Grocery Market Study Conference, Day 4 (27 October 2021).

[91] HoustonKemp International comparisons of grocery prices – further report at [14]–[20].

consumers switch to it, even though under both of these scenarios, competition is clearly increasing.[92]

95 Consistent with these difficulties in drawing any competition-relation conclusions from international price comparisons, overseas competition authorities have cautioned against the use of this sort of analysis.[93] In addition to the statement from the UK Competition Commission's 2008 market study referred to in FSSI's submissions on the draft report,[94] FSSI refers to the ACCC's 2008 findings:

95.1 the ACCC identified that grocery prices in Australia had been increasing at a faster rate than in many other OECD countries, but cautioned that food prices can increase for reasons other than the level of competition in the grocery sector,[95]

95.2 when it did use international price data, the ACCC used data on *changes* in price levels from the OECD or CPI sources,[96] and

95.3 the ACCC identified that comparisons across countries are difficult but, greater insight is possible where uncontrolled factors are similar, such as between Australia and New Zealand.[97]

Price should not be an indicator to assess whether there is workable competition in a market

96 The Commission has not tried to determine whether higher prices in New Zealand are the result of relatively less competition compared to its comparator group, or other factors.[98] FSSI has already submitted that the comparison says little about competition in New Zealand.

97 Most importantly, HoustonKemp's analysis demonstrated 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.[99] The implication of the very low sensitivity of New Zealand's international price comparison ranking 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.[100]

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[92] HoustonKemp International comparisons of grocery prices – further report at [22]–[27].

[93] HoustonKemp International comparisons of grocery prices – further report at [28]–[30].

[94] See UK Competition Commission investigation (2000) at [3.43] and [3.45], cited in FSSI's submissions on the draft report at [121].

[95] ACCC Inquiry at pages 13–14.

[96] ACCC Inquiry at pages 25–29.

[97] ACCC Inquiry at page 27.

[98] See HoustonKemp International comparisons of grocery prices at [34].

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

[100] HoustonKemp International comparisons of grocery prices at [73].

98 As such, and in combination with the difficulties outlined above, FSSI submits that price should not be used as an indicator of whether workable competition exists in the retail grocery market.

International price comparisons should be based on PPP

99 Following the discussion at the conference, FSSI remains of the view that, if the Commission continues with an international price comparison analysis, it should adopt PPP to compare prices (and not a blended market exchange/PPP rate).[101] Using a PPP conversion, New Zealand ranks 21st in the OECD. Below FSSI sets out additional information and evidence to support the perspective we presented at the conference regarding the use of market exchange rates to compare prices between countries.

100 It is appropriate to adopt a market exchange rate-based international price comparison for highly traded products or services.[102] However, most retail grocery items are not actively traded – at least not in the form in which they appear in a retail store.[103] Market exchange rate-based comparison could only apply to retail grocery products to the extent that:[104]

100.1 the products are actively traded (exported from or imported into New Zealand), and

100.2 transaction and transportation costs, as well as taxes and quarantine/biosecurity laws for that product, are sufficiently low to facilitate trade at a common domestic and international price (i.e. that cross-country arbitrage could be expected to apply – the "law of one price").

101 Dairy or meat products (as major exports from New Zealand) and bulk grains (as they are largely imported to New Zealand) may meet that criteria.[105] However, a market exchange rate-based comparison should only apply to the component of the cost of those goods that is routinely traded – it should not apply to any localised costs such as local processing and packaging for retail sale, or local storage and distribution costs.[106]

Innovation

Caution is needed when comparing innovations between countries

102 The Commission analysed innovation in the draft report by carrying out a desktop analysis that sought to compare overseas innovations to those present in New Zealand. In doing so, the Commission overlooked that FSSI had, or has plans to implement, most of the international innovations it referred to, with the exception of grocery robots and Amazon Go.

103 During the conference, the Commission asked whether an international comparison was "valid or fair". The Commission also asked whether the nature of the innovation

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[101] See FSNI's submission on the draft report at [111]-[116] and HoustonKemp International comparisons of grocery prices.

[102] HoustonKemp International comparisons of grocery prices – further report at [35].

[103] HoustonKemp International comparisons of grocery prices – further report at [36].

[104] HoustonKemp International comparisons of grocery prices – further report at [37]–[39].

[105] HoustonKemp International comparisons of grocery prices – further report at [40].

[106] HoustonKemp International comparisons of grocery prices – further report at [41].

mattered. For example, would economy of scale be relevant to some types of innovation, and not others.[107] FSSI considers that it is. As a result, while benchmarking innovations to other countries is one way of assessing this indicator, care needs to be taken:

103.1 New Zealand has a small population, spread over a large country, and its average household disposable income is less than the OECD average, and less than Australia and the United States.[108] This affects the level of innovation that customers demand,

103.2 New Zealand's relative size and population affects particular types of innovations differently. For example, the Commission noted in its draft report that New Zealand does not have an equivalent innovation to Amazon Go. FSSI does not consider that was a fair comparison. In particular:

(a) Amazon is one of the largest retailers in the world,

(b) there are less than 30 Amazon Go stores in the world. These stores are located in the US and London, with London stores only having launched in March 2021, and

(c) by comparison, New Zealand simply does not have the population density to make such an innovation viable, considering the largest capital cost associated with each store.

104 Instead, FSSI has developed SHOP'nGO technology, which is a response to the "checkoutless" trend observable overseas.

QRS

FSSI's QRS offering is consistent with workable competition

105 FSSI has submitted extensively on its QRS offerings and response to competitors in this space.

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[107] Dr Small (Commissioner) at lines 1-17, page 15 of the transcript from the Retail Grocery Market Study Conference, Day 4 (27 October 2021).

[108] OECD Better Life Index 2020.

106 The Commission noted in the draft report that it was "not clear" whether the QRS offered to consumers differs materially from what we would expect in a workably competitive market.[109]

107 During the conference, the Commission suggested it was now evaluating QRS as a particular indicator of competition.[110] FSSI responds to questions and comments raised by the Commission at the conference as follows:

107.1 FSSI has an extensive QRS offering, as discussed above.[111] This is consistent with the Commission's findings that the banners differentiate their offering and have a different approach to QRS.[112]

107.2 The Commission asked how it should assess whether QRS aspects of the retail grocery offer are consistent with overseas benchmarks. FSSI considers this is a flawed question. FSSI does not believe that it would be possible to conduct such an analysis in a principled manner – it would be an inherently subjective assessment. For example, to the extent there were QRS differences between New Zealand and another country, this may well reflect that consumers in those countries value different QRS factors, rather than being a sign that competition was not effective in either country.

107.3 FSSI considers that its QRS offer is consistent with workable competition. This is consistent with the Commission's draft finding that other retailers compete with the major retailers primarily on non-price factors, and that the major retailers differentiate their offering on price and non-price factors. These findings are also consistent with the ACCC's approach in its 2008 grocery market study, as discussed from paragraph 37 above, where it found that competition on non-price dimensions was a significant element of competition in the grocery industry and provided supermarkets with important opportunities to compete.[113] The ACCC study also found that although the major retailers compete on price, much of the competition between them is on non-price aspects of the retail grocery offer.[114]

108 In sum, should the Commission consider this indicator in greater detail for its final report, in FSSI's view its QRS offering, and that developed by other retailers, is consistent with workable competition.

Conclusion on outcomes

109 The Commission concluded in the draft report that:[115]

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[109] Draft report at [3.136].

[110] In the draft report, the Commission stated that "given our conclusions about profitability, pricing, innovation and investment, we do not consider that this affects our preliminary view in relation to the effectiveness of competition in the sector" at [3.136].

[111] See also FSSI's submission on the draft report at

[112] Draft report at [5.54] and [5.58].

[113] ACCC inquiry at pages 73-74.

[114] ACCC inquiry at pages 72-74 and 90.

[115] Draft report at page 35.

> none of these observed outcomes is, on its own, a conclusive indicator that competition is not effective. However, viewed in the round, our preliminary view is that they are not consistent with what we would expect to see if a workably competitive market.

110 FSSI agrees that none of the outcomes are conclusive, but all of the indicators support a finding that there is workable competition in the retail grocery market when "viewed in the round".

CONDITIONS OF ENTRY AND EXPANSION

FSSI's response to the discussion at the conference, and overview of this section

111 The discussion at the conference was particularly valuable in relation to barriers to entry and expansion, due to the presence of smaller competitors. The discussion strengthened FSSI's view that, other than the barriers imposed by planning law, there are no material barriers to entry or expansion for different shopping missions. It is also important to acknowledge that, unlike the Commission's position at the time of the draft report, there is no basis for an assumption that there are high barriers to entry and expansion, because:

111.1 there are not sustained excessive profits (which would suggest there is a good commercial case for entry that is not being taken up),

111.2 in any event, a profitability finding cannot be stretched so far as to draw a meaningful inference about the level of barriers to entry and expansion in a market. The latter is consistent with the Commission's updated view that there is a reduced role for profitability, and

111.3 consumer shopping behaviour is pivoting towards missions shopping, and the conditions of entry and expansion for shopping missions are quite different to those for the main shop.

112 In the following sections, FSSI provides additional evidence regarding conditions of entry and expansion, including:

112.1 the lack of barriers to entry and expansion has been borne out by the entry and expansion that has recently occurred, or been announced, including during the course of this study,

112.2 access to supply chain infrastructure is readily available from third party providers,

112.3 there do not appear to be any difficulties with obtaining capital, including both domestic and overseas capital,

112.4 scale is not a pre-requisite for competing with the major grocery retailers, and this is borne out by FSSI's experience on the ground, and

112.5 FSSI does not participate in any behaviour that might constitute a strategic barrier to entry. In any event, FSSI considers that any concerns in this regard can be addressed by a grocery code.

There is a large number and wide range of recent entry and expansion

113 The lack of barriers to entry and expansion has been borne out by the entry and expansion that has recently occurred, or been announced, including during the

course of this study. Adopting the perspective of missions shopping, and accepting the material constraint FSSI faces from many types of retailer, these examples show vibrant and meaningful constraints across FSSI's business.

114 The new entry and expansion that that has occurred or been announced since the market study commenced includes:[116]

114.1 Supie entry: May 2021,

114.2 My Food Bag expansion into groceries: August 2021,

114.3 Circle K expansion to 100 stores: announced September 2021,

114.4 Geezy Go entry: announced November 2021, planned for early 2022, and

114.5 Briscoes expansion into groceries: November 2021.

115 These examples are consistent with the points made in the following sections regarding specific aspects of the conditions of entry and expansion.

Retailers can readily access supply chain infrastructure

116 Supply chain infrastructure is readily available and does not limit entry or expansion. Any retailer will need to establish its own supply chain i.e. ambient, and chilled/frozen, storage and transport. However, any retailer has the choice of either investing in its own supply chain infrastructure, or partnering with a third party logistics provider. There are many third party logistics companies providing these services in New Zealand, which a new entrant could access.

117 Third party options are readily available and commonly used, even by vertically integrated retailers. As far as we are aware, no retailers raised concerns during the conference associated with accessing supply chain infrastructure

118 Furthermore, rapid establishment of logistics services (including for the delivery of refrigerated goods) is possible, as evidenced by The Warehouse's development of its own refrigerated delivery service for TheMarket in 2020.[117]

119 FSSI also notes that a large proportion of products are supplied by suppliers directly to retail stores utilising their own supply chain infrastructure, or third party providers. For example, approximately [REDACTED] of FSSI's SKUs are delivered direct to store.

New entrants can access capital

120 A number of retailers submitted that access to capital poses a barrier to entry and expansion.[118] However, FSSI understands that:

120.1 new entrants have experienced success in raising capital in New Zealand. For example, Supie was able to raise $2.5 million (the seed round's cap) in its

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116 This topic is discussed in more detail at paragraph 50, above.

117 https://insideretail.co.nz/2020/07/09/themarket-has-doubled-its-range-reached-over-165000-in-first-year/

118 Ms Balle (Supie) at lines 8 to 26 and Mr Edwards (Northelia) at lines 33 to 2, pages 14-15 of the transcript from the Retail Grocery Market Study Conference, Day 5 (28 October 2021).

first seed round in November this year. The raise was well oversubscribed, such that Supie has now opened a convertible note for investors who missed out,[119]

120.2 it seems unlikely there would be serious difficulties accessing capital if, as the Commission suggests, existing retailers' ROACE was in excess of 20%,

120.3 market participants do not think they would "have trouble finding" overseas investors,[120]

120.4 during the conference there were no comments that indicated that overseas capital was less advantageous than local capital,[121] and

120.5 FSSI understands Northelia has $1 billion of available funds.[122]

121 Therefore FSSI takes the view that there is no evidence to suggest that access to capital is barrier to entry and expansion in New Zealand, especially as access to overseas capital is readily available.

122 Even if access to capital was a barrier to entry and expansion, it would be a matter best ameliorated by considering issues associated with the Overseas Investment Act 2005 (OIA) regime.

There is no minimum scale required for entry, particularly when focusing on the different shopping missions

123 There is no minimum scale required for entry. FSSI's current competitors come in all shapes and sizes, including very large, medium and small retailers, competing nationally and locally for various shopping missions. For example:

123.1 larger retailers like The Chemist Warehouse and The Warehouse and soon Costco compete with the major retailers for particular grocery items, on a nationwide basis, but equally

123.2 smaller retailers, such as local greengrocers, butchers and fishmongers compete with major retailers, across PQRS dimensions, for specific shopping missions.

124 And, even entrants that compete for the main shop may well adopt a disruptive or different business model to ours. For example, Supie confirmed that it competed for the main shop using an online only offer, which drastically reduces the overhead costs associated with bricks-and-mortar stores. Another example overseas is Aldi,

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[119] https://www.stuff.co.nz/business/126948145/netflix-for-grocery-shopping-supie-raises-25-million-in-seed-round#:~:text=A%20supermarket%20start%2Dup%2C%20which,with%20over%20200%20food%20suppliers.

[120] https://www.nbr.co.nz/node/232107. Also refer to Ms Balle (Supie) at lines 24 to 25, page 14 of the transcript from the Retail Grocery Market Study Conference, Day 5 (28 October 2021), where it is noted that a key consideration for Supie is for Supie's ownership to remain in New Zealand, indicating that there would be access to capital from international investors.

[121] Ms McWha (Commissioner) at lines 40 to 9, pages 16-17 of the transcript from the Retail Grocery Market Study Conference, Day 5 (28 October 2021).

[122] https://www.stuff.co.nz/business/126546059/tex-edwards-proposed-supermarket-venture-secured-meeting-with-comcom

who competes for the main shop with quite a different range, relying heavily on private label products.

125 Retailers do not need access to scale or efficiencies to compete on price. FSSI faces price competition from a range of other retailers, including smaller retailers, for various shopping missions. The Commission's focus on scale suggests a focus on the main shop as the locus of competition, which FSSI considers to be too narrow to properly assess the nature of competition in the retail grocery market.

126 Taking these parts together, FSSI considers that there are no material barriers to entry or expansion for different shopping missions.

Any strategic barriers to entry can be addressed by the grocery code

127 There was discussion during the conference as to whether the following constituted a strategic barrier to entry:

127.1 most favoured nation clauses (MfNs), or exclusivity arrangements, and

127.2 alleged behaviour by the major retailers to discourage suppliers from offering supply to new entrants.

128 FSSI agrees with the Commission's view, expressed in the draft report, that MfNs and exclusive supply arrangements are unlikely to have a significant impact on entry and expansion in the retail grocery sector.[123] In addition:

128.1 FSSI uses MfNs in two large supply contracts to ensure we remain competitive over time and can continue to offer the best prices for consumers. Mutually agreed exclusive supply arrangements are also rarely used, and

128.2 FSSI considers these arrangements carefully under the existing Commerce Act framework to ensure that they do not have the purpose or effect of substantially lessening competition.

129 Further, FSSI expects that a grocery code, either explicitly or implicitly, should ensure that the engagement and negotiation between any supplier, wholesaler and retailer is conducted in good faith. This should address any concerns regarding the negotiation of these clauses. However, FSSI would be concerned if the Code prevented parties from negotiating genuine commercial terms in good faith and for the benefit of consumers. The FGC likewise noted that it was important that suppliers retained commercial freedom to enter into these arrangements.[124]

ACQUISITION OF GROCERIES BY RETAILERS

FSSI's response to the discussion at the conference

130 In its submission on the Commission's draft report, FSSI made the following key points:

[123] Draft report at [6.173].

[124] Ms Rich at lines 29-37, page 14 of the transcript from the Retail Grocery Market Study Conference, Day 7 (2 November 2021).

130.1 there are limitations in the information the Commission had available to it on the interactions between retailers and suppliers,

130.2 FSSI values its supplier relationships, and noted that those relationships are generally positive and constructive,

130.3 many key product categories are concentrated on the supply-side and suppliers have material bargaining power,

130.4 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 any evidence to support a finding that it anticompetitively limits the terms on which suppliers may supply other retailers,

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

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

131 FSSI confirmed its support for a grocery code focused on improving outcomes for consumers, and its willingness to work with suppliers and Government to develop a code.

132 FSSI was pleased to have the opportunity to discuss these issues in the context of the "Grocery code of conduct, private labels and collective bargaining by suppliers" conference session. FSSI has also carefully reviewed the additional submissions/material provided by submitters both prior to and as part of the conference.

133 In this part of the submission, FSSI addresses the following topics:

133.1 continuing limitations in the information the Commission has had available to it,

133.2 countervailing market power of suppliers, and

133.3 private label, including innovation and structural/operational separation.

Continuing limitations in information available to Commission, and impact on findings

134 In its draft report, the Commission reached a preliminary view 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 its submission on the draft report, FSSI submitted that 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 and pricing behaviour.

135 With its specific and practical focus, the supplier-related conference session provided very limited opportunity to discuss broader issues of competition for the acquisition of groceries, including countervailing market power of suppliers. FSSI generally agreed with the more limited approach, particularly in light of the support already expressed by Foodstuffs and WWNZ for a grocery code. FSSI also found the session valuable and constructive. However, the limitations in information and analysis available to the Commission (acknowledged in its draft report, and noted in FSSI's submission) remain.

136 It will be important that these continuing limitations are reflected in any findings in the Commission's final report. As a minimum, FSSI remains of the view that the evidence is not sufficient to properly reach the conclusions set out in paragraph 134, above.

137 FSSI's view is that the information limitations are also relevant in the context of the further steps the Commission takes to further develop its options for recommendations. More specifically:

137.1 FSSI would not support the Commission making recommendations regarding the specific content of a grocery code, and

137.2 there is no established need for enhanced collective bargaining mechanisms.

Countervailing market power of suppliers

138 As acknowledged by the Commission in its draft report, some suppliers have countervailing market power and there are a range of factors which would potentially improve the negotiating position of suppliers, including brand strength and the number of suppliers in a product category. However, the Commission reached 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 coloured and formed the basis of the Commission's analysis that followed regarding use of buyer power and ultimately potential harm to consumers.

139 The conference session provided no opportunity to discuss countervailing market power of suppliers. Conference participants also did not address FSSI's submissions on these issues. FSSI's view remains that:

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

139.2 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.

140 The market study has not assessed the largest portion of the shelf price of a grocery item – the supplier selling price to the supermarket companies.

141 Both retailers and suppliers make profits:

141.1 FSSI (and FSNI and WWNZ) has demonstrated that its profits are "normal" compared to international benchmarks and to a more correct WACC analysis for comparable NZX50 companies.

141.2 Suppliers make up the largest proportion of the cost of an item. To date the suppliers influence has not been assessed or commented on by the Commission as a factor in relation to the prices of groceries in New Zealand, or the contribution to the perceived lack of competition in New Zealand.

141.3 In categories where buyer power exists – the supplier's profitability could be above normal levels. It is FSSI's view that the Commission should address the influence that the largest segment of the value chain has on the competitive landscape for grocery prices in New Zealand.

142 We would also note that food prices are on the increase. Overall FSSI has had 30% more products changing price so far this year compared to last year. This impacts the whole range of products we sell, including many staples such as general grocery (cereals, canned goods, coffee, soups and sauces, snack foods, confectionery), frozen foods, health and beauty, laundry care, etc.

143 For the first time FSSI can recall we have major suppliers such as Heinz Wattie and Unilever increasing prices across their entire range of products. The quantum of increase does vary by category, but price increases are from 2%-20%, with a significant number of products sitting at around 15% increase.

144 FSSI does not have ability to absorb these increases and will therefore have no option but to pass them on to customers. In our view a market study should amongst other things, look at the factors that contribute to the suppliers' price including profit margins.

145 Given the size of the suppliers' contribution to the grocery value chain in New Zealand and the fact that unprecedented prices increases are being driven by those same suppliers, FSSI considers that this is a material gap in a complete analysis of the New Zealand grocery markets.

Private label, including innovation and structural/operational separation

146 The benefits of FSSI's consumer-driven private label offering were extensively canvassed in its submission on the Commission's draft report and during the conference session. These benefits were not seriously challenged by any submitter at the conference and in its additional written material, the FGC expressly state they do not dispute these benefits.

147 FSSI provides with this submission a further report from HoustonKemp, which considers and addresses the issues raised in the Castalia report on private label products prepared for the NZFGC.

148 A topic discussed at the conference was the alleged appropriation of intellectual property by retailers and the extent to which private label products are of a type where there is scope for innovation. FSSI has given further consideration to this topic and notes the following:

148.1 in general terms, both in New Zealand and in other overseas markets, private label products have been developed to "even up" an imbalance of bargaining power held by suppliers of commoditised items (who were viewed as effectively asking too much for their brand component). This, in itself, qualifies as an innovation;

148.2 as private label brands have gained greater customer acceptance (and so their own brand value), supermarkets including FSSI have extended the model to items that are less commoditised (for example, the Pams Finest range) – this too is innovative;

148.3 FSSI views both these trends as pro-competitive (so long as there is no appropriation of branded suppliers' intellectual property) because the result is that the consumer gets more choice and lower prices.

149 As discussed in the session, FSSI strongly rejects any suggestion that it appropriates the intellectual property of any branded supplier or other third party. Any broader industry concerns could be appropriately addressed in the grocery code (as is the case in Australia and the UK).

150 As also discussed at the conference, concerns regarding FSSI unreasonably favouring private label over branded products are not supported by economic theory or any evidence of such favouritism/discrimination.

151 From an economic perspective, the allegations of discriminatory or distorted allocation of shelf space are not something that a supermarket operator has any incentive to undertake. This is because shelf space allocations are critical business decisions which are made to maximise the value that is derived from constrained space and provide the best customer offer. Once the price for a contracted private label product is established, there is no reason to allocate space to that product on anything other than the usual basis.

152 This economic perspective reflects FSSI's practical experience, including the challenges FSSI faces in seeking to grow the volume of private label sold by its members. The reality of scarce shelf space allocation means there is a natural competitive tension with branded products and a commercial need for all products to perform on a competitive basis. This tension is enhanced in the case of FSSI where there is a dedicated private label team, and in light of the decision-making role played by owner-operators in stocking and placement - noting that this is very different from regulated operational separation of the type suggested by the NZFGC.[125]

153 It is also important to note that all major global retailers in the grocery industry (including Costco and ALDI) have a substantial private label offering. Intrusive regulation, beyond that which exists in other jurisdictions, may in fact deter further entry into the New Zealand market by those global retailers.

154 FSSI is open to any concerns around protection of confidential information and unfair application of ranging policies being considered as part of development of the proposed grocery code (noting that the Australian code requires the non-

[125] Staff engaged by Foodstuffs Own Brands Limited (**FOBL**) report to the FSNI CEO, Chris Quin and are responsible for negotiating purchase terms for private label products. These products are then acquired by both FSSI and FSSI (and are on-sold to their respective members). Also, support centre ranging and shelf allocation decisions are made by the support centre merchandising team, rather than FOBL. Against this integrated structure, operational separation would be a very significant regulatory intervention (with significant associated costs and risks of unintended consequences).

discriminatory application of ranging policies by retailers across both private label and branded products).

OPTIONS FOR RECOMMENDATIONS

155 In terms of the Commission's **draft options** for recommendations FSSI comments as set out below:

Improving competition for the acquisition of grocery products

156 FSSI is supportive of a grocery code for the industry, but one that's developed in conjunction with the industry and meets NZ market conditions. FSSI believes the code should set minimum standards of conduct and behaviour, but it should not constrain parties from negotiating genuine commercial terms in good faith and as they see fit. The Code should contain a disputes resolution process, but one that is not cost prohibitive or unwieldy so as to reduce its effectiveness. The Australian grocery Code is a good starting point for development of a New Zealand Code.

157 FSSI believes collective bargaining by suppliers is not in the best interests of consumers as it could actually reduce competition. There would also be difficulties in accommodating a group of suppliers who have similar, but not the same products in a category. However, FSSI will negotiate with any group of suppliers acting on a lawful basis.

Improving Outcomes for Consumers

158 FSSI has committed to making voluntary changes to simplify its pricing and promotional practices and is already working with the Commission in that regard. It does not believe that regulation is appropriate as a voluntary process will result in a quicker and robust outcome for consumers. FSSI would also note that contrary to some statements made at the Conference it works hard to provide genuine savings for consumers and takes its compliance obligations seriously.

159 FSSI believes the New World Clubcard programme offers meaningful benefits to its customers through discounts and rewards. FSSI has together with FSNI made a voluntary commitment to clarify its New World Clubcard terms and conditions and again will work with the Commission in this regard. This will include:

159.1 [REDACTED],

159.2 [REDACTED],

159.3 [REDACTED],

159.4 [REDACTED],

159.5 [REDACTED],

159.6 [REDACTED],

159.7 [REDACTED].

160 FSSI supports the adoption of a Unit Pricing Code and is willing to work with the Commission and other retailers towards industry-wide standards for unit pricing. FSSI considers the Australian code to be a useful starting point.

Improving access to suitable sites

161 FSSI supports the removal of barriers to entry and expansion by the end of use of restrictive land covenants on land being sold. However, the use of covenants with regard to new developments and leases needs careful consideration.

ACCESS TO PRODUCTS AT WHOLESALE

162 Despite a lack of evidence that it is necessary, FSSI is exploring how it could put together a commercially attractive offer to **supply products** to other retailers, in case this would give rise to potential net benefits for grocery market competition. FSSI believes that, if such net benefits are established, additional access to suppliers' products through FSSI is achievable on a voluntary basis – regulated access would be complex and difficult as well as being unwarranted in a context where there would be several competing suppliers.

163 FSSI currently wholesales to grocery retailers through Trents Wholesale Limited (Trents). Trents is a separate business division that sits inside FSSI with its own management team. Trents also has the infrastructure to support wholesaling to other grocery retailers, with its own sales team, ordering systems and call centre.

164 [REDACTED].

165 [REDACTED].

Structure of current pricing

166 In considering how to set up (and evaluate the potential success of) a wholesale offering, it is important to understand the structure of the pricing that suppliers currently agree with FSSI (and other grocery retailers). For most product categories, there are two parts to prices:

166.1 purchasing terms: the price that Foodstuffs pays suppliers for products. This price often reflects the cost savings that suppliers experience from the high volumes Foodstuffs purchases as well as any supply chain related services offered by Foodstuffs (e.g. cost to collect and distribute product via Foodstuffs centralised and integrated supply chain) which also provides efficiencies for the supplier compared to the supplier storing and distributing the product directly to the retail store, and

166.2 suppliers' trade and marketing spend: the money that suppliers spend with Foodstuffs to market, promote and discount their products.

167 Trade and marketing spend is an important part of how suppliers control how their products are presented to consumers through various channels. As groceries are differentiated products, there are several considerations in addition to sales volumes that contribute to the overall prices suppliers will agree, and the structure of those prices.

168 Suppliers (like retailers) are competing for sales of their products through retail channels. In that context, trade and marketing spend is often a key lever at their disposal. Suppliers allocate trade and marketing across retail brands in a way that they consider most likely to help them achieve their goals. [REDACTED].

169 [REDACTED].

Supply should be explored on a voluntary basis

170 FSSI's potential offering would be best achieved on a voluntary basis.

170.1 First, based on the process to date FSSI does not consider a case is made out that would justify a regulated wholesale solution. There are not competition issues that warrant it, in particular there is no monopoly facility or "bottleneck".

170.2 Secondly, based on the work carried out to date by the Commission and others, it is not clear whether wholesale access has the potential to have a substantial impact in improving retail competition. Given this, even if it were justified by a competition problem, regulation would be at best premature and at worst counterproductive. Given a regulated outcome is inevitably expensive these are very meaningful risks.

170.3 Thirdly, there are a number of complexities associated with supply to retailers, including:

(a) (as yet unknown, but potentially) varied customer demands, and

(b) uncertainties regarding whether and on what terms suppliers may be willing to deal with FSSI as a wholesaler.

171 FSSI encourages the Commission to discuss pricing with suppliers, and particularly the larger suppliers that have high shares in specific categories such as Coca Cola, Unilever and Goodman Fielder. FSSI notes that there has not been representation in submissions or at the conference from the full spectrum of suppliers, particularly larger suppliers. Better pricing, rather than any particular service or product, was an important part of the Commission's thinking on this issue. Given the significance of suppliers' pricing objectives to how any "wholesale" offer by grocery retailers would look, it is critical that the Commission understand this perspective.

172 FSSI proposes to continue to engage with the Commission as it finalises its report (and potentially beyond) and as FSSI continues to explore a wholesale offering, to the extent the Commission remains interested in this option. FSSI considers that the most appropriate recommendation the Commission could make, at this stage, would be one of continued engagement between FSSI and the Commission and/or Government, as the potential is explored.

OTHER OPTIONS FOR RECOMMENDATIONS

The Commission's recommendation to force divestment of either retail stores and/or supply chain assets is unjustified and would be ineffective

173 FSSI considers that the Commission has not established that direct intervention in retail competition by requiring the major retailers to divest retail and/or wholesale assets is necessary to improve competition and provide benefits for customers.

174 FSSI makes the following points in response to the discussion at the conference:

174.1 the Commission has not established that the nature of competition in grocery markets justifies what would be the most intrusive intervention ever implemented in New Zealand, 174.2 the Commission's Merger and Acquisition Guidelines do not raise all necessary considerations which should and would need to be accounted for when determining the appropriateness of forced divestments,

174.3 there is no specific composition of assets which if divested would produce an "effective" competitor, and

174.4 it is unclear that divestments would be practically achievable or effective. Instead there are complications and unintended negative consequences associated with divestments.

175 FSSI elaborates on each of these points below.

The Commission's draft findings do not meet the threshold for recommending forced divestments

176 Forced divestment is not a regulatory solution that should be adopted lightly. Confiscation (even with recompense) of a privately owned business for competition reasons would be unprecedented in New Zealand and, to FSSI's understanding, in the grocery sector globally. Given forced divestments are more intrusive than any intervention previously implemented in New Zealand, the competition problem justifying the intervention would also need to be unprecedentedly severe and unable to be solved by less intrusive remedies.

177 The Commission's draft findings regarding the nature of competition, even taken at face value, do not prove that any issues are unprecedentedly severe or unable to be otherwise resolved. FSSI agrees with the Commission's statement in the draft report that such an intrusive intervention should only be implemented as a last resort, only to be considered if other measures had proven not to be feasible or to be ineffective.[126]

178 As a matter of general principle, FSSI takes the view that it would be unlikely for any market study to ever identify a competition problem that would justify recommending the confiscation of private property.

179 It is not enough to say that there are other examples where divestments have been forced upon vertically integrated suppliers without consent.[127] These examples are rare, predominantly historical, and have been justified on the basis of competitive effects (i.e. the general principle identified in the paragraph above, and considered further in this section). To FSSI's knowledge, the Government has never required divestments in order to reduce market power, with the possible exception of the virtual asset swaps conducted between state-owned electricity generator-retailers.

180 Further, FSSI notes that:

180.1 the use of Telecom as an example confuses the point. The Government did not strictly require, and neither did Parliament legislatively mandate, the structural separation of Telecom. Instead, as part of its policy decision regarding its investment in an ultra-fast fibre broadband rollout nationally in

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[126] Draft report at 9.106.

[127] Mr Matthews (Matthews Law) at lines 31 to 37, page 6 of the transcript from the Retail Grocery Market Study Conference, Day 6 (1 November 2021).

2009, the Government required private sector partners bidding for its investment funding to contribute to an "open access, wholesale-only, passive fibre network infrastructure"[128] – i.e. partner participants could not be vertically integrated as Telecom was at that time. Accordingly, Telecom made a commercial decision to separate its business, and

180.2 the examples referred to in the United States, such as the Banking Act of 1933 (Glass-Steagall Act),[129] have typically applied to a sector as a whole, rather than selected participants – albeit the sector may have comprised a single monopolistic entity. This is clearly not the case in the New Zealand retail grocery market. And, to hypothetically narrow the scope of intervention, legislation that would narrow the scope of divestments or separation to entities over a minimum size threshold would establish a barrier to growth as participants would need to change their business model as they reach this threshold. Such an intervention would create perverse outcomes for committed new entrants such as Costco and Circle K.

181 Most importantly, the Commission would need to have a very high degree of confidence that any adverse conclusions on the state of competition were soundly based and had been determined following a rigorous process. As discussed in this submission, and given the analysis presented in FSSI's earlier submissions and the discussions had during the conference, it is clear that some of the Commission's draft findings on the nature of competition, particularly the constraints imposed by smaller competitors, and the Commission's findings about FSSI's profitability and innovation and international price comparisons, do not withstand scrutiny.

182 To recommend such a severe intervention, there would need to be unequivocal evidence that the potential benefits for consumers would outweigh the harms and the costs. FSSI does not believe the Commission has shown such evidence. It would be necessary for the Commission to:

182.1 have a high degree of assurance that the proposed divestment was appropriate for addressing the competition problem, and proportionate to the magnitude of the problem identified,

182.2 carry out a careful assessment of potential for unintended consequences, and

182.3 carry out a comprehensive weighing of the cost and benefits.

183 The Commission has not undertaken this analysis.

184 It is important that a high threshold be applied when considering the level of competition concerns that could justify forced divestments in order to protect New Zealand's reputation as a place to do business and provide certainty to New Zealand business owners. Confiscation of private property rights from individual owners in

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[128] Steven Joyce *Ultra-fast broadband investment proposal finalised* (media release, 16 September 2009), available at: https://www.beehive.govt.nz/release/ultra-fast-broadband-investment-proposal-finalised. To be eligible, bid participants needed to demonstrate compliance with the open access requirements in the invitation to participate, including divesting any existing retail business; see New Zealand Government Ultra-Fast Broadband Initiative Invitation to Participate in Partner Selection Process" dated October 2009, available at: https://www.crowninfrastructure.govt.nz/media/4824/invitation-to-participate.pdf.

[129] In addition, the Glass-Steagall Act was about prudential regulation, i.e. trying to solve a different problem.

New Zealand communities, especially without prior warning about the type of conduct that may give rise to this result i.e. no breach of existing law, would rightly be a frightening message to business owners and potential investors both in New Zealand and overseas. New Zealand ranked first, out of 190 economies, in the World Bank's 2020 assessment on the ease of doing business. That reputation would be damaged beyond repair by the forcible confiscation of private property rights. This raises questions regarding whether Costco and Circle K or others would proceed with their plans to launch in New Zealand in that climate.

Caution should be taken in applying the Commission's merger guidelines to assess the viability of a forced divestment

185 The Commission outlined in the draft report that the Commission's Merger and Acquisition Guidelines provide some guidance on the factors that are likely to influence the viability of a divestment, including whether there is an available purchasers, the composition of the divested assets and whether the divested assets would deteriorate in the divestment process.[130] FSSI understands the Commission is interested in industry participant's views on the applicability of the Commission's Merger Guidelines as setting a framework for divestment.[131]

186 The Commission's Merger and Acquisition Guidelines deal with voluntary sales of assets necessary to avoid an acquisition lessening competition. That question is, in principle, a completely different question to appropriateness of unilateral confiscation of private property. The considerations to be applied when setting a framework for forced divestments by an existing business would be importantly different.

187 To illustrate this point, some of the difficulties which would need to be accounted for include:

187.1 Consideration of the divesting party: In mergers, the applicant's sale of a part of the acquisition remains voluntary. The applicant would only make the voluntary sale if it was commercially advantageous to do so. Therefore, there can be a tacit assumption that following the divestment the applicant will continue to be a commercially effective competitor. Alternatively where a divestment is forced, the key consideration should be the impact of the divestment of the ongoing operational efficiency of the party who is forced to divest. FSSI notes that Foodstuffs operates a long-term network strategy identifying strategic property purchases many years ahead. This means there may well be real challenges to FSSI in getting back into catchments that have been forcibly divested, lessening the competitive constraint FSSI would pose on any new player and essentially shifting the competition problem. Further potential impacts on FSSI are discussed below at paragraph 193.

187.2 Purchaser risk: Purchaser risk in the context of a voluntary asset sale is not easily comparable to in the context of a forced divestment. In mergers, the Commission will consider the purchaser, requiring them to have the necessary expertise to operate the divestment assets as an effective long-term competitor. However, this purchaser risk is considered as a trade-off where the applicant is selling voluntarily part of an acquisition. As discussed at

[130] Draft report at 9.104.

[131] Commissioner Johnston asked about the applicability of the Commission's Merger Guidelines as setting a framework for divestment.

paragraph 187.1, it is assumed in this context that the divesting party will continue to be an effective competitor. In the context of a forced divestment this is less certain. Therefore, the threshold for considering purchaser risk would need to be considerably higher than for a voluntary asset sale. Having said that, purchaser risk does helpfully identify that, for a divestment to be successful, the purchaser of the divested assets must have, or have access to, the necessary expertise, experience and resources to be an effective long-term competitor. Given the complexity of FSSI's business, it is expected this criterion would be of real importance in any divestment process. For example, it will be important for the Commission to consider any prospective purchaser's brand proposition and marketability. There is no guarantee that consumers will want to shop with a divested competitor.

187.3 Composition risk: The composition risk associated with a forced divestment is more significant than for a voluntary sale of assets. Separation of the relevant assets would need to be practically achievable, and the assets would need to be sufficient to create a viable and competitive entity. There is a range of associated complexities which are discussed further from paragraph 188.

There is no specific composition of assets which would produce an "effective" competitor

188 When considering the potential impacts of forced divestment, it is important to consider what would be required to create a viable and competitive entity, and whether that is practically achievable. It would be much more complex than simply selecting a combination of stores from FSSI and WWNZ and giving them to a third player – without branding or a price proposition.

189 FSSI understands that the Commission is considering, in order to determine what composition of assets would be appropriate for divestment, what an "optimal" competitor would look like.[132] In the draft report the Commission suggested a successful divestment, being a divestment producing an "optimal" competitor, would require a network of retail stores, a wholesale business or access to wholesale on competitive terms, a distribution business or access to logistics services on competitive terms, and back office support at least on a transitional basis.[133] This would not be straightforward. Further, this assumes that competitors need to resemble the major retailers in order to compete. FSSI does not take the view that this reflects the nature of competition today. There is no "optimal" competitor and no minimum efficient scale required to be a viable and effective competitor to the major retailers. Instead FSSI suggests the Commission should consider what makes and "effective" competitor.

190 New and "effective" national main shop competitors are likely to have a different model to FSSI and the other major retailers. For example:

190.1 an online only model, in which case no stores are needed (Supie), or

190.2 a fully private label offering (Aldi), or

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132 [Reference to conference].

133 Draft report at 9.105.

190.3 a mixed model involving grocery and general merchandise options (Costco).

191 Further, "effective" competitors do not necessarily compete for the main shop. Most consumers purchase their groceries by way of shopping mission. Effective competitors for shopping missions come in all shapes and sizes. Only a single store is necessary to compete for a particular shopping mission.

192 FSSI takes the view that there are a number of ways to be an "effective" competitor and there is no specific composition of assets which, if divested, would create viable and competitive entity.

It is unclear that divestments would be practically achievable or effective

193 As discussed, the Commission has indicated that a successful divestment would require a network of retail stores, wholesale access, and access to logistics services and back office support. FSSI notes that there are complications and unintended negative consequences associated with the divestment of each of these assets:

193.1 <u>Retail stores</u>: FSSI's stores are individually owned, which is different from WWNZ and most other retailers. There is no fair way for force divestments across FSSI Members. Further, a divestment would need to be representative of FSSI's network. It would not be appropriate, for example, to "cherry pick" the highest volume and lowest cost to serve stores, as this may create a potentially disproportionately profitable set of stores, and a competitive disadvantage for the retailer forced to divest.

193.2 <u>Retail banners</u>: If the Commission persisted in recommending forced divestments, the major retailers would need to be treated consistently. It would not be appropriate to require divestment of an entire banner from one of the major retailers, and not the other, as this would create a huge competitive disadvantage. FSSI operates a portfolio of banners in order to compete. They are each part of one competitive package. Taking away one banner will have implications for FSSI's costs and ultimately the price paid by consumers.

193.3 <u>Wholesale business</u>: As FSSI is an integrated business with some scale shared services, there is no clear delineation in Foodstuffs' grocery retailing business between wholesale and retail.[134] That means FSSI would need to effectively create a separate wholesale business, at great cost, and amend business processes before it could be divested. If the wholesale and retail aspects of FSSI's business were separated and (even partially) divested this would likely lead to a higher cost of supplying grocery products in New Zealand as a result of:

(a) double marginalisation, by adding additional commercial margin at the wholesale level,

(b) compromised supply chain agility by adding an extra layer of complexity. As an example, one only needs to imagine how much more difficult it would be to manage the COVID-19 lockdowns, and global supply chain challenges if FSSI had to go through a separate wholesaler to source product. Even outside of COVID times, managing

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[134] [REDACTED].

FSSI's supply chain to ensure adequate stock across our stores is a complex task, and

(c) a competitive advantage being given to other new entrants – and players such as Costco and Circle K – which plan to enter on a vertically integrated basis.

Further, it is not clear that the divestment of wholesale assets would be beneficial to the new entrant. Other retailers have expressed that the key advantage sought is access to the same price the major retailers pay, including trade and marketing spend. This is not something which could be divested.

193.4 <u>Supply chain logistics</u>: There is no need to divest supply chain assets as both warehousing, supply chain logistics and transport requirement are accessible from third party providers. See paragraph 116 for more detail.

Government facilitated new entry is associated with a range of issues

194 The Commission has noted the possibility of a Government sponsored new entrant in retail or divestiture of existing stores. FSSI does not consider it appropriate to comment on whether the Government whether ought to become involved in grocery retailing, and instead notes that:

194.1 the Commission's conclusions in the draft report do not appear to warrant facilitation of entry – even taken at face value,

194.2 in the conference, no barriers to entry were raised that justify facilitation of entry. For example, building capital and building relationships with suppliers have not been raised as insurmountable barriers to entry. Instead the focus should be on other potential legislative barriers (which the Government is able to control) such as OIA, RMA and zoning issues, and

194.3 in facilitating entry there are a number of challenges which would have to be considered.

195 FSSI notes the following considerations will be relevant in determining whether facilitation entry is appropriate:

195.1 whether a new grocery retailer would increase competition or bring down prices. FSSI operates as though there is a strong prospect of new entry at all times, so we doubt this threshold is met,

195.2 whether, if there were a commercial opportunity due to high prices/profits or complacent industry participants there is a private solution, or whether the Government needs to use taxpayer money to subsidise an entrant or get involved itself. The imminent entry of Costco and Circle K and the ongoing entry of disruptive market participants such as Supie, Farro, Hello Fresh, suggest there is a real question as to whether this is the case,

195.3 whether facilitated entry would benefit all New Zealanders equally i.e. entry must equally subsidise consumers in Westport to the same extent as Christchurch, and

195.4 any other questions of policy and politics that are for the Government and voters, not existing grocery retailers, to decide on.