

COMMENTS ON THE RECOMMENDATIONS FOR THIRD PARTY ACCESS BY THE COMMERCE COMMISSION NEW ZEALAND

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Public version

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EXECUTIVE SUMMARY

1. In its Draft Report, the Commission claims that a lack of wholesale access to competitively priced grocery products is a significant factor hindering or preventing entry and expansion in the grocery sector and therefore affects competition in grocery retailing. The Commission sets out four options for achieving wholesale access:
 1. voluntary commercial arrangements;
 2. an enforceable access undertaking given by the major grocery retailers;
 3. a regulatory access regime; or
 4. structural separation of the major grocery retailers' wholesale and retail businesses.
2. The Commission sought further views on these options in its consultation conference. The Commission has not specified in any detail the precise nature of the 'wholesale access' it envisages, and any discussion of the potential regulatory risks and costs of mandated access appears cursory at best. The great range of regulatory interventions contemplated by the Commission and the open-ended nature of the wholesale access obligation that would be placed on the major retailers make a comprehensive assessment of these options very difficult. In this report I have therefore confined myself to drawing attention to the most apparent welfare implications of the options.

EFFICIENCY RATIONALE FOR VERTICAL INTEGRATION

3. In my opinion, all of the options for mandated wholesale access contemplated by the Commission will disrupt the existing organisational model of vertical integration adopted by the major retailers and give rise to a range of inefficiencies.
4. There are a number of circumstances where vertical integration is an efficient way of organising the activities of a firm, and where, conversely, enforcing vertical separation can be very costly. Firms have the option of sourcing the inputs they require in markets via arms-length contracts, or, alternatively, of producing these inputs themselves, i.e., 'internalising' their procurement. The efficiency rationale for vertical integration lies in the operational and investment interdependencies between organisational functions.
5. In my opinion, and as has also been recognised in competition law, the prevalence of vertical integration in grocery retailing in many countries, including in those where grocery retailing is intensely competitive, is an indication that this model offers significant benefits that enable these businesses to operate more efficiently and compete more effectively, to the ultimate benefit of customers. Technological advances, in combination with cost pressures and changing consumer preferences and expectations, have played a major role here.
6. In my opinion, WWNZ's operations offer an example of the efficiency gains that can be achieved from vertical integration in grocery retailing. Other than in the management of its franchise operations, WWNZ operates as a fully integrated, single firm. The clear distinction between 'wholesale' and 'retail' functions that the Commission appears to have adopted as a template in its assessment does not therefore reflect the reality of how WWNZ operates and plans its operations. While I use the terms 'wholesale' and 'retail' in this report to discuss the Commission's recommendations, and as a way of distinguishing 'upstream' and 'downstream' activities, it would –

given the many interactions and interdependencies up and down the supply chain – be inaccurate to view those terms as referring to distinct entities.

7. WWNZ operates a comprehensive national supply chain that supplies goods to its Countdown - stores, and to the SuperValue and FreshChoice franchise store network. WWNZ's 'downstream' retail and 'upstream' (buying and logistics) functions are seamlessly integrated, such that information about product sales and stocks at Countdown stores is 'visible' virtually in real-time. The upstream business combines multiple interdependent buying (sourcing, ranging, pricing, and promotions) and logistics (transport and warehousing) functions that are integral to the efficient operation of the retail stores. Given visibility of downstream sales, the processes of sourcing, marketing, and distributing goods are arranged centrally to ensure that both upstream and downstream inventories are optimised, and that the transportation of products between suppliers, distribution centres (DCs), and retail stores is done efficiently. All systems 'speak to each other' and are 'intrinsically connected'.
8. The supply of products to the franchise stores is organised largely on the basis of long-term franchisor / franchisee relationships, and is provided by Wholesale Distributors Limited (WDL). WDL also make use of WWNZ's supply network. WDL is essentially a retail franchise business. As such, it relies not on arm's-length relationships with its franchisees but on long-term relationships underpinned by significant commitments on each side, which are characterised by inherent bilateral dependence and on-going mutual adjustment when issues arise. I understand that WDL's existing infrastructure is not fit-for-purpose to become a wholesaler at scale to supply third-party retailers.

APPLICATION OF MANDATED THIRD PARTY ACCESS TO GROCERY RETAILING

9. The options for achieving mandated third party access described by the Commission encompass the gamut of measures applied in the standard 'toolkit' of (natural monopoly) utilities or 'essential facilities' regulation. The broad mechanics of regulating utilities that provide essential services is largely uncontroversial, though its application in particular instances often involves disputes. In contrast, the regulation of commercial businesses such as grocery retailers – that fall outside the conventional utility sphere and where there are no infrastructure assets that could, in any meaningful way, be considered 'essential' for third party competition – appears to be a unique and historically unprecedented initiative, and would be inherently complex and contentious.
10. Even in the context of conventional utilities regulation, in my experience, mandated separation is, at best, workable in a narrow set of circumstances:
 - First, the regulation of third party access is typically applied to natural monopolies or to 'essential' infrastructure facilities where functional boundaries are, at least at first glance, relatively apparent. This is a different situation from the one here where access is proposed to some aspects of a complex and tightly interwoven bundle of activities that the buying and logistics functions fulfill to support the efficient operation of the retail businesses, thereby meeting the needs of customers.
 - Second, even in natural monopoly and similar situations, third party access regulation has proved complex, intrusive, and prone to disputes. This experience points to some of the issues that can be expected to arise, with even greater severity, if access were applied to grocery retailing.
11. The complex interplay of upstream and downstream functions highlights broader sectoral trends that point to the dynamic and evolving nature of grocery retailing, and that make a wholesale access regime particularly problematic:

- The boundary between ‘wholesale’ and ‘retail’ is neither clear-cut nor technologically stable: not only does the location of key functions (such as where inventory is kept or which party is responsible for distributing products) shift over time, but the growth of online transactions has blurred those boundaries, making the distinction somewhat arbitrary (as illustrated by WWNZ’s ‘e-stores’ and ‘dark’ stores).
 - The move to just-in-time logistics, the growing importance of fresh produce, whose perishability can readily give rise to substantial wastage, and the need to be capable of managing shocks (such as those associated with the current pandemic) in a tight supply chain all increase the importance of strong vertical coordination. WWNZ’s handling of the shock to retailing induced by the pandemic (but also other natural disasters) highlights the efficiency benefits tight vertical integration provides in terms of flexibility, responsiveness and resilience.
 - The ongoing expansion in product variety and rapid turnover and innovation in product lines or stock-keeping units (SKUs) also increase the importance of vertical coordination and would complicate the attempt to place that coordination on a contractual basis that would be subject to regulatory oversight.
12. More generally, in my opinion, the dynamic nature of customer needs and requirements highlights a fundamental distinction between conventional utilities and grocery retailing. Evolving consumer preferences are changing not only the types of products that are appealing to customers, but also how customers shop for them. The pandemic has accelerated the trend towards online shopping with new delivery options emerging, including home delivery, curbside or store pick-up, and others. These trends have further blurred the boundary between the functions typically associated with retailing and those associated with wholesaling.

ECONOMIC COSTS AND RISKS OF WHOLESAL ACCESS

Disruption of integrated processes and loss of flexibility

13. In my opinion, third party users would reduce the flexibility and constrain the efficiency with which WWNZ organises its facilities, processes and day-to-day activities. Wholesale access would then increase the cost of serving *all* of WWNZ’s consumers for the sake of benefitting one or more entrants serving a small share of the market.
14. WWNZ purchases of products from suppliers are currently predicated on these goods being resold in its retail operations; a change in these arrangements would require the consent of suppliers. Were WWNZ to become effectively a competitor to suppliers by supplying third party retailers, suppliers may place restrictions on WWNZ or withhold their consent. It is unclear whether the Commission would then require suppliers to supply to other retailers on regulated terms.
15. Even in the simplest scenario where access is confined to the supply of wholesale products, such an arrangement would impose potentially significant costs on WWNZ in terms of:
- the need to install bespoke new systems to handle product ordering, fulfillment, tracking and billing, along with the requisite staffing;
 - the loss of operational efficiencies across its supply chain, in particular at its DCs, which are at the centre of its logistical operations; and
 - additionally, a loss of flexibility and predictability, and therefore of effective storage capacity, which would further increase costs and potentially affect quality of service.

16. In my opinion, were wholesale access to encompass additional transport and storage components, the loss of operational and other efficiencies would extend to WWNZ's logistics network. Efficient inventory management is central to minimising costs in grocery retailing, and is greatly aided by the visibility that WWNZ has of product volumes (i.e. consumer demand) at its retail stores. That visibility and the predictability of volumes that comes with it would likely be impaired by the addition of third party volumes with resulting increases in inventory costs and risks, in particular because the Commission appears to consider information confidentiality a key part of an access regime.
17. WWNZ's products are currently distributed to stores so as to meet overall system objectives, including by taking account of DC and store inventory capacity, as well as item level, store level, and aggregated volume forecasts, and with the flexibility to utilise the most appropriate store delivery method, including direct store delivery (DSD) channels negotiated with suppliers. To the extent that this flexibility is reduced to accommodate third parties' distribution requirements, supply costs can be expected to increase.

Pricing inefficiencies

18. All access regimes circumscribe the discretion of the access provider in the pricing and delivery of their services. The efficiency with which these terms are set is therefore a crucial aspect to the efficiency consequences of the proposed wholesale access regime.
19. In the case of the wholesale access contemplated by the Commission, challenges as to what costs and prices should be charged to third party retailers arise at different stages of the supply chain:
- The most immediate relate to the costs of modifying WWNZ's existing systems and putting in place new systems to handle the sale and/or logistics of supplying wholesale products to third party retailers, as well as the staff required to operate these systems.
 - There are material questions around how any 'wholesale price' for products would be determined. As a fully integrated firm, WWNZ operates as a single profit centre – much as economists would expect in an activity characterised by pervasive efficiencies of vertical integration. I understand that while averaged product costs are allocated to Countdown stores, warehouse costs are not, and Countdown stores do not pay a wholesale margin. There is therefore no 'price' against which an obligation to "provide supply on non-discriminatory terms", as referenced by the Commission (Para. 9.49.4) can be measured. Further, I understand that WWNZ negotiates promotional rebates with suppliers in return for specific marketing efforts that are executed in Countdown stores. Passing on promotional rebates to third party retailers would (if permitted by suppliers) effectively enable these to 'free-ride' on WWNZ's (and suppliers') marketing efforts, potentially reducing WWNZ's incentives to seek and offer those promotions in the first place.
 - Where logistics services are concerned, I understand that WWNZ does not apply the type of activity-based costing approach that would be needed to accurately allocate logistics costs to retail stores, and has not determined accurate 'costs to serve' for either Countdown or franchise stores. One of the consequences of access would therefore be the need to establish a differentiated distribution charging framework that reflected storage and locational costs, a significant and complex undertaking. It is, indeed, an open question whether a charging framework that would guide efficient decisions by a third party could be devised in a context characterised by pervasive joint costs and significant non-linearities.
20. There are additional circumstances where regulatory determinations of price and non-price conditions of access for vertically integrated commercial businesses pose specific challenges.

Regulated pricing structures rarely reflect opportunity costs, for instance, as a result of the loss of operational flexibility in WWNZ's vertical supply chain, which may result in an increase in the costs of storing and distributing WWNZ's own merchandise.

Dynamic inefficiencies

21. In my opinion, a key concern with mandated access in grocery retailing relates to the incentives to invest in new capacity, technologies and processes, or to introduce new products, both on the part of the access provider and on the part of the access seeker.
22. Unlike in a conventional regulated utility framework, there is no guarantee that investors in privately owned facilities will see their funds returned. It is true that in some regulated utilities, investors bear a degree of risk; but the risks are likely to be much greater in the scenario which seems to be envisaged by the Commission, as the quantum and duration of demand are entirely unpredictable. Compounding those risks is the fact that third party access vests access seekers with a right but not an obligation to use the facilities of the access provider. This creates an asymmetry in the distribution of returns from an investment:
 - the 'downside' is placed entirely on the access provider who would need to underwrite the long-term investment required to support third party access; while
 - the 'upside' is shared with third parties.
23. In theory, an omniscient regulator could take those risks into account in determining the terms and conditions of access. In practice, given the entirely unprecedented nature of this regulatory intervention, and the inherent complexities of determining and allocating costs in grocery, it would be difficult for investors to have much confidence in a regulator's ability to fully and properly take those risks into account.
24. The cost of capital to retail grocery would therefore rise; and the incentives on the part of the access provider to undertake significant investments (such as supply chain automation), especially in facilities that are innovative or relatively risky, would be reduced. By the same token, an access seeker assessing the trade-off of falling back on the essentially riskless option of regulated access versus undertaking an investment (that may in fact be better suited to their own entry or expansion plans) may elect to postpone or cancel such an investment. To the extent to which this occurs, society is worse off, as otherwise efficient, innovative investments are unnecessarily deferred or even entirely foregone.

Dispute costs and strategic behaviour

25. Mandated third-party access redistributes income between market participants – most obviously between the access provider (whose shareholders will generally lose from the mandated access requirement) and access seekers who, at least in the short run, can hope to gain. The scope for such redistribution can create formidable incentives for 'rent seeking': securing for oneself a larger share of any economic rents that may be available. Rent seeking absorbs resources that could have been put to productive use elsewhere, and amounts to a pure waste of society's scarce resources that is unlikely to be in the interests of consumers.
26. Costs arising from 'strategic behaviour' arise because the parties to an access agreement have conflicting interests, and have incentives to manipulate processes to their own advantage. These incentives are likely to be greater for third parties who would likely account for only a small share of any wholesale products, and for whom there is correspondingly little downside, for instance by

entering into disputes or invoking arbitration provisions. In my opinion, this is a plausible scenario in the current context where the major retailers may need to accommodate a number of (would-be) retailers, who would stand to lose little by disputing the terms of access.

27. In my opinion, the scope for strategic behaviour is compounded by the apparent intention of the Commission to place wholesale access obligations on both of the two major retailers. Such an approach, which adds to the unprecedented nature of the proposal, would in turn raise the question of which party would bear the obligations, and whether access seekers would be required to enter into long-term commitments, or could play off the access providers against one another, increasing the risks each face.

Competition and cost trade-offs

28. In my opinion, the Commission has not properly considered the trade-offs between enabling greater competition, on the one hand, and the costs of achieving that competition, on the other.
29. The potential efficiency losses of its wholesale access proposals for the major retailers are not discussed in the Commission's Draft Report. These are the unintended inefficiencies regulation brings with it, including operational inefficiencies that are introduced as a result of third party access, the harm caused by settling inappropriate terms and conditions of access, and the disincentives third party access creates for investment and innovation.
30. In my opinion, any competition benefits that might arise as a result of implementing the Commission's proposals would not outweigh these costs. Such competition benefits would be diminished by the fact that any entrant will, to a greater or lesser extent, be a copy of the incumbents. The greater the extent of entry facilitation, the less differentiated it will be:
- Access seekers sourcing their wholesale products from the major retailers would compete for customers on the basis of substantially the same cost to serve. They would, moreover, compete for customers on the basis of the same product range and quality as that offered by the major retailers.
 - It therefore seems unlikely that wholesale intervention would facilitate vigorous price competition, as for example pursued by Aldi and Costco (both of whom rely on their own supply chains and have an extensive range of own-brands). Indeed, the presence of these assisted entrants may make entry (or expansion) by such fully integrated firms, which could offer genuine head-to-head competition, more risky and less likely.
31. My concern about crowding out genuine entrants and competitors in the New Zealand retail market also relates to the radical nature of the Commission's proposals. In contrast to the conventional public utilities, in which the bulk of costs were incurred long ago (and only require gradual renewal), grocery retailing requires high levels of ongoing investment.
32. In my view, a decision to impose a regime such as that proposed by the Commission would greatly increase the perceived riskiness of investment, especially foreign investment – both in this industry and more generally in New Zealand. In particular, current and future entrants and competitors are likely to take note of what is a very significant intervention in the market. Enormous care therefore needs to be exercised before floating, much less taking forward, proposals of that kind.

1. INTRODUCTION

33. I have been engaged by Woolworths New Zealand Limited ('WWNZ') to provide my opinion in relation to the recommendations made by the Commerce Commission New Zealand ('the Commission') in its 'Market study into the retail grocery sector' (the Draft Report, 29 July 2021). For the purposes of this report, I have been asked to comment on the options identified by the Commission for mandating access to products at the wholesale level.
34. As an economist, I have a long-standing interest in the retail grocery, as well as in access regulation more generally.
35. As Counsellor for Structural Policy in the Economics Department of the Organisation for Economic Cooperation and Development (OECD), I directed the OECD's first study of the structure and performance of distribution systems, which focussed heavily on grocery retailing in 1990-91. Undertaking this study required me to become familiar both with the economics of grocery retailing and with the specifics of the sector in a wide range of OECD economies, which I did through extensive site visits, meetings with industry leaders, discussions with officials, consultation of documents and data analysis.
36. Since leaving the OECD, I have retained my interest in the sector, and have at various times served as a consultant to Woolworths and Metcash in Australia, particularly in relation to mergers and acquisitions, and to regulation. I have also worked for many years as a consultant in other industries related to retail grocery, notably the pharmacy sector, which in Australia operates largely through banner groups that are similar to those found in retail grocery.
37. Additionally, I have been involved in regulation and regulatory economics ever since I led the OECD's first study of the scope for competition in telecommunications, in 1979-1981. Since then, I have had an ongoing interest in the regulation of third party access, with my involvement in those issues covering virtually every industry that has been regulated in Australia, or has been considered for regulation. A summary of some of the papers I have written on these issues are appended to this statement, with copies available on request; and a copy of my book on telecommunications regulation is also available on request. Also attached is my CV.
38. I note that the analytical arguments advanced in this report draw on a number of my earlier papers, including (Ergas 2009) and (Ergas 2013), in which I have elaborated on the following points:
- Vertical integration is an efficient business structure in many industries because it internalises a number of potential externalities related to pricing, service quality, investment and adaption to change;
 - As a result, governments should be wary of intervening to alter industry structure in ways that can undermine the benefits vertical integration provides;
 - Mandated third party access is a significant and intrusive intervention which fundamentally alters the property rights of the access owner relative to the access seeker, setting up a difficult bargaining process between the two entities that must be adjudicated by a third party regulator; and
 - The process of economic regulation can itself introduce new risks and distortions which are difficult, if not impossible, to avoid, and that have the potential to damage efficiency, reduce competition and harm consumers.

2. THE COMMISSION'S OPTIONS FOR WHOLESALE ACCESS

39. In its Draft Report the Commission claims that a lack of wholesale access to competitively priced grocery products is a significant factor hindering or preventing entry and expansion in the grocery sector and may consequently affect competition.¹ The Commission identifies four options for wholesale access to promote competition:
1. voluntary commercial arrangements under which the major grocery retailers could supply grocery products to third parties on competitive terms;
 2. an enforceable access undertaking given by the major grocery retailers;
 3. a regulatory access regime; or
 4. structural separation of the major grocery retailers' wholesale and retail businesses.
40. The Commission claims (without offering any evidence as to why such outcomes would be possible or even likely) that wholesale access could enable:
- retail entry by non-grocery retailers, and expansion by existing firms;
 - entry or expansion by an additional major grocery retailer;
 - stronger competition from independent grocery retailers; or
 - more online grocery offerings.

2.1. VOLUNTARILY NEGOTIATED COMMERCIAL ARRANGEMENTS

41. The Commission claims that the major retailers have the systems in place to provide (would be) retailers with wholesale grocery supply, a claim that WWNZ has advised the Commission is incorrect. According to the Commission, the existing wholesale arrangements could therefore be extended to third party retailers.
42. I note that WWNZ has stated that no wholesale interventions in the retail grocery sector are required.² WWNZ has also stated that following a sufficient passage of time and subject to the resolution of a number of complexities, WWNZ would have an open mind to entering into voluntary wholesale supply arrangements.
43. However, the Commission appears to discount voluntarily negotiated commercial agreements, given that, in its opinion:
- independent grocery retailers may have concerns about relying on the major retailers for their wholesale supply; and
 - the major retailers would have limited incentives to supply retail competitors.
44. I do not agree that voluntarily negotiated commercial arrangements would not be effective. First, such agreements would take the form of negotiated contracts such as those that underpin commercial transactions in any market economy. The mere fact that such contracts are not

¹ Commerce Commission New Zealand, 2021. "Market study into the retail grocery sector", Draft report, 29 July.

² WWNZ, 2021. "Woolworths New Zealand Limited's submission on the New Zealand Commerce Commission's draft report regarding the market study into the retail grocery sector", 10 September, pp.24 ff.

'regulated' (other than through the normal provisions of the law and the courts) does not imply that either party could step away from an agreement. Rather, precisely because such an arrangement would be voluntary, it would not impose the rigidities and consequent inefficiencies third party access regulation inevitably involves. On the contrary, unlike mandatory access, it could allocate risks efficiently and align incentives between the parties, making the agreement self-enforcing and ensuring that it involved gains from trade.

45. Second, there is already at least one instance of such a voluntary negotiated agreement. Woolworths Australia has entered into a long-term wholesale supply agreement with Caltex (now Ampol), and is in the process of scaling up its business-to-business operations to compete with Metcash.³ The trademark 'Australian Liquor & Grocery Wholesalers' has been registered in Australia, covering two classes of goods and services including retailing, wholesaling, distribution and storage of goods and logistics services.

2.2. ENFORCEABLE ACCESS UNDERTAKING

46. The Commission describes an enforceable access undertaking as (p.305) as "a written statement from an access provider to the Government or a regulatory agency setting out the provider's arrangements for providing access to one or more of their services". The Commission notes that a commercial relationship between parties will generally be less costly than a regulatory solution. Nonetheless, according to the Commission, firms may require a greater degree of confidence in their wholesale supply arrangements before investing to enter or expand in the retail grocery market than would be implied in a purely commercial relationship.

2.3. ECONOMIC REGULATION OF ACCESS

47. The Commission describes access regulation as designed to provide access to an essential input to facilitate competition in downstream or related markets. The Commission notes that, at this stage, it does not consider the direct regulation of access pricing to be desirable. The form of access regulation preferred instead by the Commission is one that aims to increase the viability of actual and potential competitors. Such a wholesale grocery regulatory regime would likely include:
- an obligation to publish, or to provide on request, standard terms for the supply of products, e.g., dispute resolution and termination;
 - an obligation to provide supply to any member of a class of businesses that meets certain minimum criteria, e.g., creditworthiness;
 - an obligation to maintain confidentiality of information from the third party retailer, in particular in relation to staff involved in the retail operations of the majors or their related firms; and
 - an obligation to provide supply on non-discriminatory terms: terms that are, in substance, equivalent to those provided to its own retail businesses.

2.4. OPERATIONAL SEPARATION

48. The Commission describes operational separation as entailing separate management, employees, and information systems in the major retailers' respective 'wholesale' and 'retail' businesses.

³ <https://www.afr.com/companies/retail/woolworths-ramps-up-b2b-operations-16-years-after-exiting-wholesale-20181105-h17imd>; accessed on 1 November 2021.

According to the Commission, operational separation would additionally offer would-be competitors sufficient certainty to make the investments necessary to enter or expand into retail grocery markets, and to sustain innovation in the long term.

2.5. VERTICAL SEPARATION

49. The Commission describes vertical separation as requiring existing market participants to structurally separate their 'wholesale' businesses from their 'retail' grocery businesses. According to the Commission, additional rules would be needed to address cross-shareholdings, including partial or full divestment of the restructured business. The Commission notes that structural separation and potential divestiture would involve significant costs and potential risks, and appears to consider this option as a 'last resort'.

2.6. THE COMMISSION'S PROPOSALS IN CONTEXT

50. In my opinion, the Commission has not undertaken an evaluation of the options for wholesale access, and any discussion of the potential regulatory risks and costs appears cursory at best. Instead, the options described by the Commission encompass the gamut of measures applied in the standard 'toolkit' of utilities regulation, which become progressively more severe in terms of costs, complexity and intrusiveness. Listed so that each measure incorporates all of the obligations of those that precede it, that 'toolkit' includes:

- a duty to deal in good faith with third parties;
- an obligation to provide third party access either on negotiated terms, subject to binding arbitration, or on the basis of an offer that has been approved by a regulator;
- operational separation, whereby the regulated supply of services to the third party is the responsibility of a specific business unit within the access provider, which is subject to confidentiality and reporting requirements;
- functional separation, in which the specific business unit that supplies third party access, although still forming part of the overall corporate structure, is required to be essentially stand-alone, including through separate remuneration and incentive arrangements for its staff; and
- structural separation of the wholesale and the retail business divisions, which may or may not involve divestiture.

51. It is worth emphasising the disconnect between the access regulation proposed by the Commission and the circumstances in which such regulation is typically applied. Third party access regulation is applied to firms in the utilities sector with natural monopoly characteristics, as well as (more controversially) to certain 'essential facilities' with natural monopoly characteristics and where access is deemed essential to the ability of rivals to compete.⁴ In Australia, the 'essential facilities doctrine' is reflected in Part IIIA of the *Competition and Consumer Act 2010*, which establishes a legal regime to facilitate third party access to certain services provided by means of significant infrastructure facilities, provided that a list of criteria are met. Perhaps the most important of these is Criterion (b): that the facility in question has 'natural monopoly characteristics'.⁵ Part IIIA further

⁴ Areeda, P., 1989. Essential facilities: an epithet in need of limiting principles. *Antitrust Lj*, 58, p.841.

⁵ The Competition and Consumer Amendment (Competition Policy Review) Bill 2017 amended Criterion (b) to refocus the test to a 'natural monopoly' test. See also: Parliament of the Commonwealth of Australia, 2016-2017. *Competition and Consumer Amendment (Competition Policy Review) Bill 2017*, Explanatory Memorandum.

defines a 'service' to mean a service provided by means of a facility, which includes the use of an infrastructure facility such as a road or railway line; handling or transporting things such as goods or people; or a communications service or similar service. In contrast, except to the extent that it is an integral but subsidiary part of the service, the Part IIIA access regime explicitly exempts: the supply of goods; the use of intellectual property; or the use of a production process. In the successive reviews of Part IIIA, the desirability of exempting the supply of goods from the national access regime has been repeatedly confirmed, not least because of the complexities (discussed in greater detail below) which a mandated requirement to resupply goods purchased from a third party inevitably creates.

52. In my opinion, the criteria and exclusions for access under Part IIIA serve to illustrate how far removed the Commission's proposed interventions are from 'regulatory norms'. Thus there is no sense in which any of the 'facilities' used by WWNZ – in the main warehouses or distribution centres (DCs) – can be deemed to have natural monopoly characteristics, as the reality of competing retail grocery chains highlights. Indeed, as far as the underlying facilities are concerned, I understand that:
- all but one of WWNZ's DCs are owned by third parties and are leased by WWNZ;
 - there are a number of large and well-funded institutional investors (and other entities) in New Zealand who specialise in industrial property such as retail DCs; and
 - The Warehouse operates two significantly sized DCs in the North and South Island, respectively.⁶
53. There is similarly no sense in which the transportation function could be said to have natural monopoly or similar characteristics. Indeed, as is the case for DCs, I understand that WWNZ organises its transport and logistics via contracts with third parties such as Halls, Linfox and Mainfreight. The supply of (wholesale) goods, finally, could not be 'declared' under the Part IIIA access regime, given that goods would generally bear no relation to a (perceived) lack of competition in markets for infrastructure services.
54. As I discuss in the following, as best as can be told the Commission has not specified in any detail the precise nature of the 'access' it envisages. In my opinion, the great range of regulatory interventions contemplated by the Commission and the open-ended nature of the wholesale access obligation that would be placed on the major retailers therefore make a comprehensive assessment of these options very difficult. In this report I have therefore confined myself to drawing attention to the most apparent welfare implications of the options.

3. VERTICAL INTEGRATION AND MANDATED THIRD PARTY ACCESS

55. In my opinion, all of the options for mandated wholesale access contemplated by the Commission would disrupt the existing organisational model of vertical integration adopted by the major retailers to a lesser or greater extent. To assess the corresponding welfare implications, it is important to see that there are a number of circumstances where vertical integration is an efficient way of organising the activities of a firm, and that, conversely, enforcing vertical separation can be very costly.

⁶ <https://www.nzherald.co.nz/property/giant-red-shed-centre-up-for-grabs/VP6MNYZJ7NAKDXIUFA7DKPGOYA/>; <https://www.stuff.co.nz/business/industries/79654004/giant-13-million-expansion-for-the-warehouses-distribution-centre>; accessed on 1 November 2021.

3.1. EFFICIENCY RATIONALE FOR VERTICAL INTEGRATION

56. There are clear economic reasons why (some degree of) vertical integration is an efficient organisational form in many contexts, as set out in a large theoretical and empirical industrial organisations literature.⁷ Below I briefly summarise the findings that are relevant in the current context.

3.1.1. Theories of arms-length contracting versus internalisation

57. Firms have the option of sourcing the inputs they require in markets via arms-length contracts, or, alternatively, of producing these inputs themselves, i.e., ‘internalising’ their procurement. Theories of vertical integration essentially analyse this problem and the circumstances when one option is likely to be more efficient than another.

58. The main strands of the vertical integration literature highlight the importance of the ‘transactions costs’ of organising economic activity between independent firms or agents as central to the advantages of firm integration.⁸ These are the costs of finding and qualifying trading partners, establishing specifications and prices, negotiating and drafting contracts, and of enforcing such contracts.⁹ In the presence of transaction costs, firms integrate when this is a less costly way of doing business than undertaking transactions at arm’s length in the marketplace.

59. The economic literature identifies a range of circumstances when transaction costs may be sufficiently material to make vertical integration an efficient organisational structure. These costs arise in the context of market ‘imperfections’: a lack of information about uncertain future events and corresponding difficulties in devising and enforcing arm’s-length commercial contracts governing the ongoing terms of trade. If these imperfections are material, entering into a contract with an independent party is costly and/or risky:

- Difficulties with contracts occur if firms are unable to foresee all possible contingencies that might arise in an uncertain future. This means that contracts are necessarily ‘incomplete’, simply because it would be nigh impossible (or very costly) to incorporate the range of possible uncertain events and the required responses in a contract. It may also be inefficient to do so, simply because most future events can likely be accommodated at a lower cost after the uncertainty has been resolved.¹⁰
- Moreover, even if it were possible to incorporate all possible future contingencies in a contract, it may not be possible to enforce it. This may be because it is difficult or impossible to monitor or verify contract performance, or because there are ‘commitment’ problems (for instance, if

⁷ For two surveys, see: Lafontaine, F. and Slade, M., 2007. Vertical integration and firm boundaries: The evidence. *Journal of Economic Literature*, 45(3), pp.629-685. Bresnahan, T. and Levin, J., 2012. 21. Vertical Integration and Market Structure (pp. 853-890). Princeton University Press.

⁸ The economics literature often refers to the double plural ‘transactions costs’. ‘Transaction costs’, as used here, are to be understood as synonymous with that term.

⁹ Following Dahlman (1979: 148), endorsed by Coase (1988: 6). More specifically, transactions costs comprise the costs incurred by parties to a contract in order to find each other, exchange information, delineate the property rights to be transferred, draw up the conditions of the contract, signal preparedness to fulfil their obligations, monitor each other’s performance and otherwise see to it that obligations are fulfilled, and take action if obligations are not fulfilled.

¹⁰ Klein, Benjamin, “Why Hold-ups Occur: The Self-Enforcing Range of Contractual Relationships”, *Economic Inquiry*, Vol.XXXIV, July 1996, 444-463. Page 447.

one party has an incentive to opportunistically renegotiate the contract once the two parties are locked into a close relationship).

60. Transaction cost theories essentially suggest that firms will elect to vertically integrate to reduce the likelihood and cost of haggling and exploitation. Particularly important in this respect are the inefficiencies that arise out of 'vertical externalities': that is, situations where each firm in a vertical chain takes decisions which, viewed separately, are profit-maximising, but which are collectively suboptimal for the vertical chain because they do not take account of the interdependencies between the vertical layers. Accordingly, there are a range of circumstances under which firms choose to integrate, namely when (Lafontaine Slade 2007):

- transactions are complex;
- specific investments are involved (e.g., investment in physical and human capital, in dedicated assets, or in specific (co-located) sites);
- quality is difficult or costly to verify; and
- the environment is uncertain, including when external changes require firms to adapt and innovate.

61. In my opinion, the last two points are particularly relevant to retail grocery. In contract theory, the issue of measuring 'quality' is commonly referred to as that of 'costly state verification' which, along with adverse selection and moral hazard, is one of three main sources of contracting failure. As I explain in Para. 83, there are potentially a number of incentive conflicts that would arise were upstream and downstream grocery businesses each to pursue their separate objectives, rather than those would be faced by an integrated business. Under an arms-length contractual agreement, such areas of conflict would need to be constantly monitored and enforced, making for costly and potentially dispute-prone processes. Examples where such conflicts might arise include the sharing of (proprietary) information, say in relation to planned innovations, or, specifically for the retail business, in relation to the quality of products, the need to maintain (costly) shelf-space for a range of products, as well as the need to execute marketing initiatives that the upstream business may have agreed with suppliers. In this context, it is interesting to note that the issue of ensuring that such initiatives are executed as agreed with suppliers appears to be one that has resulted in worse purchasing terms for Metcash relative to the integrated Australian supermarket chains (Merrett and Smith 2013, p.4):¹¹

In the past manufacturers of branded products undertook their marketing but today this role has largely passed to the supermarket chains and Metcash. Coles, Woolworths and Metcash negotiate with manufacturers and other suppliers for 'promotional monies' to be used for various purposes, including to pay for the 'rental' of display space and to fund periodic price discounts. It is here that the independent sector has claimed to receive poorer terms, in part reflecting an inability on the part of the independent wholesaler to guarantee that retailers would abide by the terms negotiated with suppliers. More recently, Metcash has largely addressed this via the conditions on which it supplies its retailers. Metcash does not directly charge its retailer customers for its service but retains part of the promotional money for this purpose, which has caused friction between the parties.

62. In my opinion, uncertainty and a rapidly evolving environment are also important characteristics of retail grocery, and key reasons why vertical integration is an efficient organisational form. As I set

¹¹ Merrett, A. and Smith, R.L., 2013, August. The Australian grocery sector: structurally irredeemable? In Supermarket Power in Australia Symposium, Melbourne (Vol. 1).

out in Para. 103ff. the integrated nature of the downstream and upstream business enables WWNZ to manage disruptions (including as a result of unforeseen events), for instance by sharing resources and supplies across the network. More generally, as I describe in Para. 75, technological advances and continuously changing consumer preferences make for a dynamic sales environment in which ongoing coordination between organisational functions of the business is essential to maintaining the competitiveness and relevance to customers of the retail stores.

63. A related subsequent literature on vertical integration incorporates other market imperfections into the analysis. For instance, property rights models concern themselves with how vertical integration changes the incentives to make specific investments, given that ex-post bargaining may occur. Decision rights models focus on how coordination between firms is best achieved, for instance, where there are potential conflicts or trade-offs between increasing product variety and maintaining economies of scale. Incentive theory models focus on financial incentives of economic agents and are particularly relevant to research on franchising arrangements (an intermediate form of vertical integration).
64. While all of the above theories describe the circumstances when it is efficient for a firm to vertically integrate, integrating activities within a single firm is not itself costless. Clearly, a firm that acquires all its downstream service providers may simply become too complex and unwieldy to manage and operate efficiently. Given these trade-offs, in a theoretical equilibrium, the range of activities carried out within the firm will extend to the point where the value of the benefits from integration equals the increase in the associated costs.
65. Overall, however, the economic literature identifies a range of circumstances when transaction costs may be sufficiently material to make vertical integration an efficient organisational structure. In my opinion, these are relevant considerations when considering the efficiency implications of the Commission's wholesale access proposals.

3.1.2. Vertical integration in retailing

3.1.2.1 WWNZ supply chain

66. I understand that other than with respect to its franchise operations, WWNZ operates as a fully integrated, single firm. WWNZ operates a comprehensive national supply chain that delivers goods to WWNZ's Countdown stores, and to the SuperValue and FreshChoice franchise store network.
67. Where WWNZ's main retail brand Countdown is concerned,¹² I understand that the retail and upstream functions, including the buying (sourcing, ranging, pricing, promotions) and associated supply chain and logistics functions such as transportation and storage at WWNZ's DCs are fully integrated. WWNZ computer systems monitor information about product sales and stocks at Countdown stores, as well as specific shelf holding capacity, by item, by store. Individual stores assess daily downloads of the information collected via a replenishment system that informs the quantum of orders that will need to be placed with suppliers.¹³ Given this visibility of downstream sales (and corresponding future sales forecasts), the processes of sourcing, marketing, and distributing goods is arranged centrally to ensure:

¹² I understand that there are around 180 Countdown retail stores.

¹³ I understand that store replenishment processes take into account daily sales and stock positions, shelf holding capacity as well as future sales forecasts.

- that customer needs and preferences are met;
- that supermarkets are operated efficiently;
- that both upstream and downstream inventories are optimised; and that
- the transportation of products between suppliers, DCs and retail stores is done efficiently.

68. All systems 'speak to each other' and are 'intrinsically connected'.

69. I understand that WWNZ's systems in relation to sourcing products for Countdown stores make up an integrated supply chain that ranges from product suppliers to the final customer:

- There is a single central buying team which selects the product range in consultation with suppliers and utilising internal sales data, consumer insights and analytics derived from in-store and online performance, which is then sourced from suppliers, and stocked in DCs and stores. WWNZ conducts over 200 range reviews each year. To be effective, WWNZ's buying team need to understand and manage a range of factors that span the supply chain, for instance the need to:
 - optimise limited shelf space, and understand processes and operational capacity in retail stores;
 - manage supply chain constraints, and support efficient logistics practices;
 - manage supplier dynamics, including supplier capacity and capability;
 - deliver competitive prices, and compelling promotions; and
 - ensure product ranges are suitable and quality is high.
- WWNZ forms long-term partnerships with suppliers to design, manufacture and supply new private label products. Private label sourcing is handled by a specialised team within WWNZ. WWNZ works with private label manufacturers to maintain an up-to-date private label offering that is informed by consumer preferences, as observed in retail stores.
- WWNZ partners with fruit & vegetable growers which may include upfront commitments to buying the 'whole of crop' (as opposed to opportunistic, transactional buying) for supply to retail stores. Relatedly, WWNZ is able to offer private label brands such as "the Odd Bunch", which makes a virtue of 'non-standard' sized vegetables in its retail stores.
- WWNZ operates an exclusive partnership with Hilton Food Group to cut and pack meat (and ready meals) for supply to retail stores.
- WWNZ operates a single buying team for Countdown that determines retail prices, including promotional initiatives that are coordinated with suppliers and executed in retail stores (Para. 115).¹⁴

70. As I understand it, WWNZ's network of 11 DCs (four ambient DCs, one Toll-owned indent overflow DC, three Americold-owned chilled & frozen DCs, and three T&G-owned produce DCs) plays a central role in the context of coordinating the retail and buying functions. The DCs are strategically located across New Zealand to hold product inventories for distribution to WWNZ's Countdown and franchise retail stores. The DCs' floor designs match the specific product range held by a DC so as

¹⁴ WDL also has a small buying team for the franchise business, which undertakes some management of recommended pricing for franchisees, as well as negotiation of WDL direct-to-store delivered products.

to achieve operational efficiencies in picking and assembling store deliveries. I understand that inventory and transport arrangements are coordinated centrally and vary by type of product and other considerations:

- DC capacities, layouts, locations and operating processes are designed around the stocking requirements of retail stores;
- pallets with stock are selected to match the layout of stores to achieve efficiencies; for instance, where possible all boxes for the same grocery aisle are 'picked' on the same pallet;
- 'ambient' products that do not require special handling tend to be stored in and distributed from WWNZ's DCs;
- there are separate dedicated supply chains for imports, chilled and frozen products, meat and poultry, and fruit and vegetables;
- some products that are not suitable for central distribution (such as some perishable products) are sent to stores via 'direct store delivery' (DSD), which is managed and funded by individual suppliers; however,
- other factors also play a role in the decision to utilise the DCs or DSD, including DC capacity, the ability to obtain cost savings if suppliers undertake deliveries, or supplier preferences.

71. Ex-DC, I understand that delivery times and routes are designed to maximise end-to-end efficiency. The logistics operation adjusts to the requirements of Countdown stores. Conversely Countdown stores adjust to the requirements of the logistics operation, for example by accommodating deliveries at odd hours if that is operationally efficient.
72. I understand that the supply of products to WWNZ's franchise business (provided by Wholesale Distributors Limited (WDL) to supply SuperValue and Fresh Choice stores) also makes use of WWNZ's supply network.¹⁵ WDL has its genesis within the South Island grocery wholesaler Rattrays Wholesale Group, and is essentially a retail franchise business. I understand that WDL is not currently fit-for-purpose to become a wholesaler at scale to supply third-party retailers.
73. I understand that the supply of products to the franchise stores is based on long-term franchisor / franchisee relationships. There are ongoing interactions between franchisees and WDL, including for promotions which are organised by WDL. Ordering processes for franchisees are not fully automated; rather the stores place their orders for products with WDL, in which case ambient, chilled and frozen products pass through the WWNZ distribution network, with other products delivered direct-to-store by suppliers via a charge through a process administered by WDL.¹⁶ In practice, the franchise stores also negotiate and purchase some products from third party suppliers.¹⁷ More broadly, I understand that while the franchisee – WDL relationship is governed by franchise contracts, interactions can be described as a 'give and take', consistent with a long-term, mutually beneficial relationship.

¹⁵ I understand that there are around 70 franchise retail stores.

¹⁶ []

¹⁷ []

3.1.2.2 Technological and consumer trends favouring vertical integration

74. Vertical integration is a feature of many major supermarket chains across the OECD area. Tesco, Sainsbury's, Asda, Coop and Morrisons in the United Kingdom, Coles, Woolworths, Costco and Aldi in Australia, and other major international retailers, including Kroger, Walmart, Carrefour, Lidl and Mercadona (which operate in the United States, the European Union and South America), are all vertically integrated. Even upstream entities that appear to be vertically separated – such as Metcash in Australia – are best described as having a high degree of 'quasi-integration' with their franchisees, where that quasi-integration takes the form of extensive control over the franchisees' retail operations. While there are some entirely separate wholesale entities, for instance in the United States, they tend to service smaller retail outlets, or smaller collections of retail outlets.
75. In my opinion, the ubiquity of vertical integration in grocery retailing in many countries—including those where grocery markets are undoubtedly strongly competitive—is an indication that this model offers significant efficiency benefits that enable these businesses to compete more effectively, to the ultimate benefit of customers. I understand that vertically integrated retailers also represent an effective, reliable model that appeals to suppliers seeking to invest their discretionary promotional funding. Technological advances, in combination with cost pressures and changing consumer preferences and expectations, have played a major role here (see also Box 3-2):
- Barcode scanners and associated software enable up-to-date inventory management and automated ordering systems that effectively merge the retail and wholesale levels. These new tools offer real-time, fully integrated visibility of inventory and sales throughout the vertical chain, enable a better understanding of customer demand, and facilitate optimising stock levels to minimise costs and wastage. Tracking and scheduling software optimises truck loads and deliveries to balance inventories. These are efficiencies that can be attained across the vertical supply chains, but they require close cooperation, including through tight managerial coordination and extensive information exchange, between the downstream and the upstream parts of the business.
 - At the same time, evolving consumer preferences are changing not only the types of products that are appealing to customers, but also how customers shop for them.¹⁸ The pandemic has accelerated the trend towards online shopping with new delivery options emerging, including home delivery, curbside or store pick-up, and others. These trends further blur the boundary between retailing and wholesaling, in the sense that e-commerce sales may in part or entirely bypass traditional retail stores, and instead may be supplied through what would conventionally be regarded as the upstream operation, or through other retail or hybrid assets.
76. In my opinion, the growing importance of online transactions is merely one aspect of a number of broader sectoral trends that have increased the importance of vertical integration in grocery retailing. Other developments that make vertical integration more efficient than contracting between distinct businesses include:
- The ongoing expansion in product variety—which reflects rising consumer incomes and the broadening in consumer tastes—along with rapid turnover and innovation in product lines or SKUs increase the importance of vertical coordination and would complicate the attempt to place that coordination on a contractual basis (Box 3-1). In effect, greater product variety increases the

¹⁸ Abbu, H.R., Fleischmann, D. and Gopalakrishna, P., 2021. The Digital Transformation of the Grocery Business-Driven by Consumers, Powered by Technology, and Accelerated by the COVID-19 Pandemic. In *WorldCIST* (3) (pp. 329-339).

number of contingencies that would need to be covered, monitored, and enforced under a contract. This is because, while product variety caters to a wider range of customer preferences and increases the aggregate demand for products, it tends to reduce the demand and increase the sales volatility for an individual variety.¹⁹ This effect would exacerbate incentive conflicts and coordination problems between vertically separate businesses along the value chain:

- For the downstream businesses, product variety increases production costs by compromising economies of scale, increasing overhead costs, and lowering worker productivity. It also increases inventory costs as the downstream business has to keep extra inventory to account for unexpected variation in customer demand across varieties.
 - New products and product variety can also exacerbate information asymmetries between the upstream and downstream business. For instance, the downstream business will have better information about customers' willingness to pay for various products, but may not accurately share that information with the upstream business, say, to maintain its profitability. On the other hand, an upstream firm might hesitate to share proprietary information about technological innovations and new products down a (separate) value chain.
- The move to just-in-time logistics, the growing importance of fresh produce, whose perishability can readily give rise to substantial wastage,²⁰ and the need to be capable of managing shocks (such as those associated with the current pandemic) in a tight supply chain all heighten the importance of strong vertical coordination. WWNZ's handling of the shock to retailing induced by the pandemic (but also other natural disasters) highlight the efficiency benefits tight vertical integration provides in terms of flexibility, responsiveness and resilience, but also in terms of avoiding the disputes that may well arise in an arms-length, commercial relationship (see also Box 4-1).

Box 3-1. The increasing number of Stock Keeping Units (SKUs)

Between 2010 and 2021, the number of active barcodes across WWNZ's largest grocery categories (e.g., toiletries, cleaning products, biscuits, accounting for about 50% of total WWNZ sales), increased from [9,265] to [10,324] or by more than 10%. The steady increase of 1% per year in the number of barcodes across the major grocery categories comes despite periodic efforts to rationalise product lines (such as in 2016 when WWNZ reduced the number of toiletry brands). It reflects current trends towards more dynamic, more multi-dimensional (e.g. health), and more locally curated ranges, requiring ongoing data-driven optimisation that a vertically integrated business is far better placed to provide. There is also evidence of a higher turnover of SKUs, as brands become ever more targeted to specific groups of consumers. This trend is supported by technological innovation in the grocery industry that has allowed for near real time monitoring of consumer preferences.

Generally, for large brands (suppliers), the trend has been to continuously innovate and increase the number of SKUs. While small brands may offer fewer individual SKUs, the number of small brands is rapidly increasing. Moreover, the number and share of private-label products is also growing at a brisk pace (McKinsey 2019), albeit WWNZ notes that private labels are to date less mature in the New Zealand market.

¹⁹ Zhou, Y.M. and Wan, X., 2017. Product variety and vertical integration. *Strategic Management Journal*, 38(5), pp.1134-1150.

²⁰ I understand that WWNZ currently arranges for the supply of fruit and vegetables to Countdown retail stores from three DCs owned by T&G Global, one of which will be replaced by a new produce DC being built in Wiri.

As shelf space is limited by store size and layout, accommodating an increasing number of SKUs involves difficult trade-offs, whose management requires a great deal of detailed sales information, ideally obtained on a real-time basis. Additionally, there is a global trend towards smaller stores opening in space-constrained, inner-city markets, exacerbating shelf space challenges. These trends make supply chain optimisation increasingly complex, compounding the need for thorough reviews of what should be listed or removed from the assortment and hence making access to detailed information about retail sales ever more essential (McKinsey 2019).

In summary, the consequences of steadily increasing SKUs include the costs of carrying a wider assortment of products, which include:

- maintaining relationships with a wider number of suppliers;
- holding the necessary storage space in DCs and retail stores;
- arranging smaller order multiples for larger varieties of products;
- difficulties in streamlining fulfillment due to complex picking practices;
- a higher likelihood of fulfillment errors due to SKUs being confused with others; and
- more complex inventory management.

Vertically integrated grocery businesses are better able to manage these consequences by ensuring on-going coordination between functional layers.

Sources: McKinsey, 2019. Data supplied by WWNZ.

77. The prevalence of vertical integration in grocery retailing has been recognised in competition law. Thus, while in *ACCC v Metcash Trading Ltd*, the Australian Competition and Consumer Commission (ACCC) asserted that Metcash operated in a wholesale market for groceries while its franchisees operated in separate retail markets, the Federal Court, in its decision at first instance, rejected that contention, noting that: “*Metcash is not simply a wholesaler*”, but rather Metcash is “*closely involved in the retail process, partly through ownership but mainly through contract*”.
78. The trial judge concluded that [Justice Emmett, para 342]:²¹
- “I am not persuaded that there is a separate market for the wholesale supply to independent supermarket retailers of packaged groceries, as the Commission defines those terms in the Statement of Claim. The Commission has based its case solely on there being a separate market for the wholesale supply to independent retailers of packaged groceries, as defined. The Commission’s pleaded case as to market definition has not been made out. It follows that the proceeding must fail.”*
79. The decision at first instance was upheld in the Full Federal Court on Appeal and the ACCC subsequently did not pursue the matter further in the High Court. In the Full Federal Court Decision, Justice Yates noted that [para 266]:
- “.. as a matter of principle, there is no reason why, for competition law purposes, a market cannot be defined by reference to multiple functional levels.”*
80. As I have noted above, since that decision, the boundaries between wholesale and retail operations in the grocery business have become increasingly indistinct, while the practical integration between the functional layers has become more pronounced. As a result, I do not believe that the terms

²¹ [2011] FCA 967 (25 August 2011); [2011] FCAFC 151 (appeal).

'wholesale' and 'retail' identify clearly distinct entities in retail grocery, much less that they define distinct markets as the term is generally used in competition law and policy.

3.2. MANDATED SEPARATION AND ACCESS

81. Before discussing the efficiency implications of the Commission's proposals for WWNZ, I first comment on the role of third party access regulation more generally. In my opinion, mandated separation is, at best, workable in a narrow set of circumstances:

- First, the regulation of third party access is typically applied to natural monopolies or to 'essential' infrastructure facilities where functional boundaries are, at least at first glance, relatively clear and stable. In my opinion, this is a different situation from the one here where access is proposed to some aspects of a complex and constantly changing bundle of goods and services that the upstream wholesale operations provide to the retail outlets.
- Second, even in natural monopoly and similar situations, third party access regulation has proved complex, intrusive, and prone to disputes. In my opinion, the experience with third party access regulation points to some of the issues that can be expected if access were applied to grocery retailing.

3.2.1. Third party access and natural monopolies

82. Enforceable access undertakings and regulated wholesale access (both of which are a form of quasi-separation) and structural separation have generally been viewed as instruments to be applied to vertically integrated natural monopolies, with the aim of separating the natural monopoly element from the layer or layers which are potentially competitive.²² The industries at issue are typically public utilities, where the natural monopoly component is a reticulation network whose boundaries are relatively well-defined and stable. In the distribution of electricity, gas and water, for instance, the basic components of the infrastructure technology have remained relatively unchanged over many years, although there has been significant innovation in some areas (such as metering and telemetry). In telecommunications, in contrast, technological innovation has been more rapid and has blurred many of the lines between the wholesale and retail layer, which contributed significantly to the complexity of telecommunications access regulation, notably in the period prior to the transition to very high speed, fibre optics based, access networks.

83. The clarity and technological stability of the boundaries between the natural monopoly layer and the potentially competitive layers is central to the feasibility of replacing vertical integration by separation or quasi-separation; that is, of replacing managerial control over the vertical process with contractual relations between the monopoly and competitive layers. Even in those cases, and particularly where access regulation has expanded into areas where the natural monopoly characteristics of a facility are questionable, separation has imposed significant efficiency costs. These reflect the difficulty of devising contractual substitutes for the managerial controls that operate in a vertically integrated entity. The causes of the inefficiencies include:

- difficulties in specifying the quality to be provided;
- difficulties in handling shocks which disrupt service provision within the vertical structure;

²² In the Australian context, Part IIIA of the Competition and Consumer Act 2010 permits the services of certain infrastructure facilities (for instance, railway tracks, airports, or port terminals) to be declared for third party access in some circumstances.

- losses in the extent, quality, and timeliness of information flows between the vertical layers, particularly when the access seekers may have incentives to conceal or distort information;
- difficulties in optimising capacity expansion along the vertical chain, particularly when expansion involves vertical coordination and sharing of costs;
- difficulties in balancing the need for long-term commitments (which are required for planning and securing efficiencies, for example in procurement) with the need for flexibility in the face of uncertainty; and
- the scope each of these factors creates for prolonged and costly disputes.²³

3.2.2. Application of third party access to the grocery sector

84. The Commission notes that administering access undertakings, access regulation or operational separation would likely need “*some degree of external monitoring and independent audit to ensure compliance*” (Para. 9.54). In my opinion, this is an understatement. As best as I can tell, no similar regulatory measures have been applied to the grocery sector within the OECD area or in any other part of the world. In contrast to natural monopoly industries, grocery retailing has none of the characteristics which have made it possible to contain the inefficiencies associated with access regimes in the conventional public utilities space. If anything, innovation in the sector makes it even harder to believe the Commission’s proposals could pass a cost-benefit test.
85. To see this, it is important to appreciate that, as I have discussed at Paras.66ff. WWNZ’s upstream ‘wholesale’ function combines multiple interdependent and complex services that are integral to the efficient operation of the retail outlets.²⁴ In my opinion, the complex interplay of these various functions highlights a number of broader sectoral trends that point to the dynamic and evolving nature of retailing, making a wholesale access regime particularly problematic:
- As explained above, there is rapid innovation in retail grocery, and the boundary between ‘wholesale’ and ‘retail’ is neither clear-cut nor technologically stable (Box 3-2). Not only does the location of key functions (such as where inventory is kept or which party is responsible for transporting products) shift over time, but the growth of online transactions has blurred those boundaries, making the distinction somewhat arbitrary.
 - At the same time, for reasons discussed above (see para. 76) the move to just-in-time logistics, the growing importance of fresh produce and the steadily rising number of, and turnover in, SKUs, increase the importance of tight vertical integration and make third party access costlier to design and implement.

Box 3-2. Technological innovation and disruption in grocery retailing

The growth in online sales is reshaping grocery retailing internationally, including in terms of the way companies in the sector structure their operations. Thus, online competitors such as Amazon have increased their product assortment (both for pantry and fresh foods), have invested in advanced data analytics to personalise customers’ shopping experience, and

²³ Illustrations of these efficiency consequences in a range of industries can be found in Gómez-Ibáñez, J.A., 2009. Regulating infrastructure. Harvard University Press.

²⁴ As I note at Para. 71, the supply of products to WWNZ’s franchise business (provided by Wholesale Distributors Limited (WDL) to supply SuperValue and Fresh Choice stores) also makes use of WWNZ’s supply network, although WDL negotiates and coordinates the sourcing of some different goods, from different suppliers (delivered direct to store), as outlined at Para. 72 .

have changed how customers receive groceries. Along the way, they have reorganised their operations in a way that increasingly blurs the boundaries between retail and wholesale.

Amazon acquired Wholefoods in 2017, enabling the expansion of 'Amazon Fresh' services to new markets. Amazon has expanded its physical grocery operations to include cashier-less Amazon Go stores, Amazon Fresh grocery stores, and hundreds of Whole Foods locations. The company opened its first Whole Foods 'dark store' during the pandemic to quickly process online orders. In the United States, as of April 2019, Amazon's e-commerce offering included:

- Delivery of Whole Foods Market products through the Prime Now app in no more than 1 hour in 75 metropolitan areas; and
- Grocery pickup from Whole Foods Market stores through the Prime Now app in 30 metropolitan areas.

Amazon launched its food and grocery offer in Australia in 2018.

Other retailers have followed suit. Walmart and Kroger offer two-hour, same day curbside pickup or home delivery. Instacart, which launched in 2012, offers grocery delivery and pick-up services to traditional brick and mortar grocery stores (including Costco); it has expanded rapidly and can reach more than 80 percent of US households.

Where customer density is low, investments in large fulfillment centres, delivery fleets, and drivers for on-line purchases are not viable. As such, some major grocers are using their stores as fulfillment centres. Amazon, Target and Walmart all use local stores as e-commerce fulfillment locations. For market participants such as Amazon and Alibaba, the grocery divisions do not necessarily need to be profitable as stand-alone entities; instead, the retail operation supports the overall profitability of the grocery business by securing daily traffic, customer loyalty and engagement.

Overall, e-commerce has shifted the functional boundaries in retailing, with order fulfillment taking place in warehouses, in 'dark stores', and in traditional brick and mortar retail stores, and customer pick-up and delivery taking place at stores, at the curbside, or at customers' homes.

WWNZ's 8,800-sqm 'e-store' in Auckland is an example of this functional shift. The Penrose e-store features all the regular supermarket elements, including a bakery, butchery and shelves stocked with packaged grocery items and fresh produce, but is not accessible to walk-in customers. Instead, a team of over 200 'personal shoppers' fulfil online orders for customers from what were originally ten of Countdown's busiest Auckland supermarkets. The e-Store operates 24-hours, seven days a week and is capable of completing more than 15,000 online orders weekly, aided by a layout based on sales data that increases picking efficiency. The first delivery trucks leave the store at 6am daily, with final deliveries departing at 7pm.

Sources: Abbu and Gopalakrishna, 2021. McKinsey & Company, 2020. McKinsey & Company, 2021. <https://www.newshub.co.nz/home/money/2020/04/countdown-opens-new-zealand-s-first-purpose-built-permanent-e-store-in-auckland.html>; accessed on 1 November 2021.

86. Finally, as I set out in Para. 138, the fact that there would be potentially two access providers in each of the North and South Island (i.e., WWNZ and one of the two Foodstuffs co-operatives) creates a novel scenario that would not be encountered in regulating natural monopolies (or indeed essential facilities). In effect, two competitors would then potentially become subject to mandated access regulation with all the costs that this entails, to accommodate an unknown number of third party access seekers and for an uncertain period of time. I note that the Commission provides no indication of how the fact of having two, competing but supposedly essential, facilities would be managed.

87. I elaborate on the implications of all of these elements for the costs and risks of mandated access in the following sections.

4. ECONOMIC COSTS AND RISKS OF WHOLESALE ACCESS

88. To my knowledge, and despite a number of reviews by competition authorities, no country has instituted a wholesale access regime, much less enforced vertical separation, in retail grocery. For reasons set out in the following, mandated access arrangements will, in my opinion, disrupt WWNZ's vertically integrated supply chain and result in considerable operational inefficiencies, as well as negative consequences for investment and innovation. There is additionally a significant source of costs and risks that is inherent in the novelty and complexity of the regulatory regimes that the Commission appears to advocate.

4.1. DISRUPTION OF OPTIMISED PROCESSES AND LOSS OF FLEXIBILITY

89. As a general matter, a loss of productive efficiency (whereby goods and services are no longer produced at least cost) can arise when efficient processes within a firm are disrupted as a result of mandated third party access. Additional users may reduce the flexibility or otherwise constrain the efficiency with which facilities or processes can be organised. This is of particular concern in industries such as grocery retailing where coordination has to take place in real-time and in a manner that adapts to changing circumstances and events.

90. In my opinion, the extent to which third party access would disrupt existing processes and thereby raise costs depends on which of the Commission's options is applied, but also on the scope of the access regime, which the Commission has not defined. Thus, 'access to products at the wholesale level' could imply requiring WWNZ to provide third parties with:

- access to wholesale goods at wholesale prices (however such prices are defined); or
- access to a bundle of goods and services, including the wholesale goods and additionally storage and/or transportation services.

91. In either case, I understand that the supply of wholesale goods to access seekers who would then resell these in their stores would require the agreement of suppliers. WWNZ currently buys products from suppliers on the basis that these products will be resold in its own retail operations. Suppliers may not agree to changed terms as related to third party retailers for two reasons:

- WWNZ would effectively act as a new competitor to suppliers who also maintain their own delivery channels for smaller stores; and
- suppliers may be concerned that any rebates or discretionary spending for marketing or promotion efforts which they may have negotiated with WWNZ (which are then reflected in the cost price that WWNZ pays for the relevant products) may not be executed by third parties.

92. It is unclear how the Commission would proceed if supplier consent became a material hurdle, for instance whether wholesale access would be extended to include suppliers, or whether the Commission would seek to coerce suppliers to change their terms and conditions.

4.1.1. Access to the supply of wholesale goods

93. If access is limited to the supply of wholesale goods, one could envision a system whereby individual third party retailers would place orders with WWNZ for the supply of certain products.

94. It is important to note that even in this case the precise scope of the obligation on WWNZ would raise serious and difficult issues because the range of products WWNZ stocks changes frequently (Box 3-1). It is, as a result, by no means clear quite what WWNZ would be required to do in terms of meeting access seeker demand, yet the precise content of the obligation would have important consequences for the impacts on efficiency and on competition. For example, it is entirely conceivable that the access seeker would want continued access to a particular product or variety of product that WWNZ intended to discontinue.²⁵ Were WWNZ required to nonetheless meet that demand, its costs would rise, both in terms of the cost of goods sold and in terms of handling costs. If DC space were filled with unique products for specific retailers, the DC would become less productive, and stock movement would be slower. Such an outcome would also mean that WWNZ could not pursue other opportunities and product innovations, given limited DC space. There is an obvious question of how these opportunity costs would be recovered, which is made all the more difficult by the risk that situations of that kind would give rise to recurring disputes. The practical ability of any regulatory arrangement to manage an ongoing stream of those disputes, in a situation where the parties' interests diverge, must be in serious doubt and cannot simply be assumed away.
95. Even assuming that the precise scope of a product supply obligation could be properly defined, being required to accommodate a third party would have significant effects on the performance of WWNZ's operations.
96. The Commission notes that the major retailers appear to have the systems in place to provide wholesale grocery supply, and that (Para. 9.40): "we are not aware of any supply-side or regulatory issues that would prevent these wholesale arrangements being extended to include supply to other retailers on competitive terms". In the case of WWNZ and its subsidiary WDL, I do not believe that the Commission's assessment is correct.
97. I understand that while WDL maintains an IT system to supply its franchisees, that system is not fit for purpose to extend to third parties at scale (Paras. 71f.). As a result, an assumption that WDL could handle the access requirement is not realistic in my opinion:
- WDL's wholesale system could not remain as it is, but even assuming it could with some retro-fitted additions, the variable costs of meeting the entrant's (or entrants') requirements would be very high, as WDL's operations struggled to manage additional transactions and greater sales complexity; or
 - WDL would need to purchase and implement entirely new information, operating and control systems, which could meet the requirements both of dealing with access seekers and of complying with the separation regime, imposing high fixed costs and substantial investment risk.
98. As I have set out at Paras. 67f., I understand that at present WWNZ gathers sales information from its Countdown network centrally, and organises purchases from suppliers and the logistics of distributing products to retail stores largely without manual store input. WWNZ does not therefore operate conventional wholesale ordering or billing systems that could be extended to third parties. WWNZ would then need to put in place entirely new, parallel systems to accept orders from third party retailers, compile and transmit these orders to different suppliers, arrange for billing services, and to track the flow of goods to individual third party retailers. Additionally, given confidentiality

²⁵ This has occurred on a number of occasions under Part XIC of the Australian Competition and Consumer Act, forcing the access provider to continue providing the declared services, typically at a loss. See also the SKU management discussion at Box 3-1.

requirements and other constraints of the Commission's mooted access regime, those order flows would somehow need to be segregated and shielded from the systems and people involved in managing the flow of goods to WWNZ's own retail outlets. Again, even were that physically feasible, the upfront cost of such systems are likely to be significant, without any assurance that these costs could be recouped.

99. In my opinion, and given the complexity of WWNZ's sourcing and distribution arrangements, access to wholesale goods would pose an immediate question as to where and how ownership of goods would be transferred. For instance, while ambient products tend to be stored and distributed from WWNZ's network of DCs, not all products are handled in this way. Inventories for perishable and other products are held at separate dedicated DCs, while inventories for products such as bread and milk are held by suppliers and then distributed via DSD. In effect, wholesale access would:
- require WWNZ to sell and transfer products to third party retailers from infrastructure facilities which have not been designed for these types of transactions; and
 - similarly require suppliers of certain products to accommodate third party sales, including in terms of scheduling, collecting goods and placing them on pallets, and handling truck flows at their facilities.
100. As I describe at Para. 70, WWNZ's DCs handle specific product types, and are laid out in a manner that optimises the process of picking and consolidating goods for transport to Countdown and franchise stores, and for productive management when goods arrive in individual stores. I understand that these facilities have been sized to handle WWNZ's inventory requirements (which in turn reflect the projected flow of goods to retail stores, including occasional demand peaks) and are set up to process efficiently the transfer of products to WWNZ's transport fleet (which in turn conforms to physical DC and retail store requirements). These facilities have not been designed to accommodate the transfer of (potentially relatively small) batches of goods and associated independent third party pick-up schedules. I understand that requiring such a change would materially disrupt the efficiency with which the DCs can operate, as well as potentially raising health and safety issues.
101. In my opinion, the loss of visibility of a share of downstream retail throughput also has important consequences for how WWNZ dynamically manages capacity and compensates for demand variations. At present, WWNZ has sight of real-time sales trends at its Countdown stores, and a good understanding of throughput at its franchisee stores. As a result, WWNZ is able to assess and project sales at retail stores and therefore throughput its DCs with considerable confidence, thus minimising unnecessary inventory costs, and enabling it to allocate the right number of personnel in its supply chain (e.g., at its DCs).
102. At the same time, given the integrated nature of the downstream and upstream business, WWNZ is able to smooth over disruptions (including as a result of unforeseen events) by limiting the quantities delivered to its stores or by instituting equitable sharing arrangements (Box 4-1). Under a wholesale access regime, this type of visibility and flexibility would likely be diminished with associated costs for WWNZ and its customers:
- I would not expect that third party retailers would agree to the kind of information sharing that currently takes place within the WWNZ supply chain. Indeed, the Commission's proposal for regulated access specifies, among other things (Para. 9.49.3), an obligation "*to keep confidential the information provided by independent grocery retailers and, in particular, not to provide that information to staff involved in the retail operations of the major grocery retailers or their related*

firms". With that loss of information and visibility comes a reduction in the ability to predict aggregate product volumes.²⁶ All things equal, meeting WWNZ's own retail store delivery standards combined with those of third party retailers may then require WWNZ to hold more inventory and/or to accept a greater likelihood of outages and therefore a reduction in service quality. In my opinion, this type of situation would likely be a recipe for access disputes that would need to be adjudicated by the regulator.

- The loss of flexibility would be reinforced if WWNZ were required to segregate its DCs to accommodate third parties. Segregated inventories would reduce WWNZ's ability to secure economies of massed reserves, require it to significantly reorganise its processes for picking and assembling goods within the DCs, and cut down on effective warehouse capacity which is already constrained at some DCs (Para. 123). This, in turn, raises the possibility that WWNZ would need to invest in additional capacity to accommodate third party access seekers. Yet, unlike a conventional regulated utility, WWNZ would be forced to do so without any certainty of cost recovery, which would in turn likely lead to a more piecemeal and therefore higher cost supply chain solution for New Zealand.

Box 4-1. Vertical supply chain responsiveness to demand shocks

WWNZ's vertically integrated supply chain has enabled flexible and rapid responses in a number of unpredictable and unforeseen circumstances in recent years. Thus, during the Covid-19 pandemic, WWNZ ensured that retail stores could cope with a surge in demand by instituting a number of policies across its network.

As NZ went into lockdown in late March 2020, Countdown reported that weekly customer registrations for online ordering increased tenfold. Investment had already been underway, and by mid-April 2020, WWNZ's first customer-free 'e-Store' in Penrose was ready to meet the COVID-induced sudden surge in online demand (Box 3-2).

In order to meet the surge in retail demand WWNZ also:

- ensured that all stores, including franchise stores, were supplied with products on a 'best endeavours' and as, far as possible, – equitable – basis so that potential product shortages could be shared across the network;
- reduced store hours to give staff more time to stack shelves so as to reduce panic buying at the prospect of empty shelves;
- opened six 'dark stores' to cater for the rush for online purchases;
- prioritised deliveries to the most vulnerable such as those over 70 years and/or who have serious chronic illness (with more than 16,000 customers accepting this service);
- placed purchase limits on certain products and limited in-store customer numbers;
- suspended promotions for a time to limit the strain on the downstream network;
- provided rent relief for small business tenants co-located on WWNZ property;
- increased contactless payment requiring a PIN from NZ\$80 to NZ\$200;
- provided a bonus of 10 per cent per hour to waged supermarket and distribution centre team members over the course of the four-week Level 4 alert lockdown in 2020;
- partnered with suppliers to convert products from DC supplied into DSD to free up DC capacity; and
- worked with suppliers to consolidate production into higher volume lines (e.g., for mince).

²⁶ The classic reference in this respect remains Kenneth J. Arrow: Vertical Integration and Communication; *The Bell Journal of Economics*, Vol. 6, No. 1 (Spring, 1975), pp. 173-183, showing that the ability to seamlessly communicate information about retail sales provides a powerful impetus to vertical integration, as the improved forecasting accuracy it provides allows efficiencies in the use of capital.

During the 2016 earthquake in Wellington retail store orders were diverted to WWNZ's Auckland DC while the Palmerston North DC was closed. Equally, during the 2011 earthquake in Christchurch, WWNZ was able to keep about half of its stores open and supplied drinking water to the affected region.

It is questionable whether these responses in a situation of acute supply shortages would have been possible in a less tightly vertically integrated environment. One of the key points to note is how difficult it would be to define, much less demonstrate, that access seekers had been treated no less favourably than WWNZ's own operations and its franchisees. Moreover, implementing these responses required both far-reaching administrative direction on Countdown's own retail outlets and a long-standing cooperative relationship of goodwill with franchisees. In contrast, faced with disruption, there must be a substantial risk that an entrant would act opportunistically, privileging its commercial interests above those of the retail system as a whole.

Source: WWNZ; <https://www.countdown.co.nz/news-and-media-releases/2016/october/countdown-network-update>, accessed 1 November 2021.

103. In summary, in my opinion, even in the simplest scenario where access is confined to the supply of wholesale products, such an arrangement would present considerable difficulties and impose potentially significant costs on WWNZ in terms of:

- the need to gain the consent of suppliers to essentially take on a wholesale function, in competition with suppliers and notwithstanding existing rebate agreements, to supply third party retailers;
- the need to install bespoke new systems to handle product ordering, fulfillment, tracking and billing, along with the requisite staffing;
- the loss of operational efficiencies across its supply chain, in particular at its DCs, which are at the centre of its logistical operations; and
- additionally, a loss of flexibility and predictability, and therefore of effective storage capacity, which would further increase costs and potentially affect quality of service.

104. To that extent, wholesale access would increase the cost of serving *all* of WWNZ's consumers for the sake of benefitting one or more entrants serving a small share of the market.

4.1.2. Access to the supply and distribution of wholesale goods

105. In my opinion, were wholesale access to encompass both the supply of wholesale goods and additionally storage and/or transport services, the loss of operational and other efficiencies would potentially extend to the logistics network.

106. Before exploring why that would be the case, however, it is important to ask why the Commission might consider that mandated access to warehouse space or to some combination of warehousing and transportation services might be warranted in the first place. As I have noted at Paras. 52f., I understand that:

- there are well-resourced private sector investors and developers of warehouse space, including those leasing DCs to WWNZ, and that recent DCs developed for WWNZ have been funded by external parties; and
- there are also private transport service providers that presumably could (and would have commercial incentives to) offer any access seeker similar services as those that WWNZ contracts for with third party freight providers.

107. If the Commission did have in mind some form of composite wholesale access (including potentially logistics services), it would then force a major retailer such as WWNZ to provide access to services that WWNZ itself purchases from third parties—and which access seekers could themselves acquire directly. Even putting aside the complex contractual issues that requirement would create, in my opinion this paradox shows that the Commission's proposed interventions are entirely unrelated to the conceptual basis for access regulation, either as regards (natural monopoly) utilities regulation or even access to essential (infrastructure) facilities.
108. As I have noted at Paras. 96f. above, I understand that WDL's systems are not fit for purpose to extend to third parties at scale. I understand that WWNZ also does not have the systems in place to track the sale of wholesale products to third parties at scale, nor does WWNZ have the systems capability to further manage third party sales through its downstream distribution network. Installing and resourcing such systems would likely represent a significant upfront cost of wholesale access with the associated investment risk.
109. As I have set out, WWNZ monitors its Countdown store network in close to real-time and automatically distributes goods to the stores in a manner that minimises logistics costs overall. This degree of visibility within a vertically integrated system bestows scheduling and planning flexibility on WWNZ, permitting WWNZ to minimise inventory and transportation costs:
- DCs are located, set up and organised to ensure efficient inventory, handling and delivery of a reasonably predictable volume of products to the WWNZ's network of stores, including the franchise stores;
 - the distribution fleet, including the contract fleet is designed to serve the existing DC and store network, including in terms of catering to retail stores' loading capabilities; and
 - transport schedules balance trucking costs across the DC/retail store network with the costs of holding inventories at different locations.
110. In my opinion, wholesale access that also included a (transport and storage) logistics component would disrupt other key aspects of WWNZ's supply chain:
- As I noted above, efficient inventory management is central to minimising costs and is greatly aided by the visibility that WWNZ has of product volumes at its downstream outlets. That visibility and the predictability of volumes that comes with it would likely be impaired by the addition of third party volumes with resulting increases in inventory costs and risks. The fact that the Commission appears to consider information confidentiality to be a key part of an access regime (Para. 102) makes these efficiency losses all the more certain.
 - While it seems plausible that the distribution fleet could be expanded to service a larger number of stores, the flexibility with which it could be deployed would likely be reduced. Any access regime would likely prescribe fixed delivery timelines. Indeed, any access seeker is likely to demand such timelines in order to efficiently undertake its own short- and medium-term planning. As I have noted at Para. 70, products are currently distributed to stores so as to meet overall system objectives, including by taking account of DC and store inventory capacity, and by using DSD distribution channels when this is appropriate and cost-effective. To the extent that this flexibility is reduced via additional constraints as a result of wholesale access, supply costs can be expected to increase.

4.2. PRICING INEFFICIENCIES

111. In my opinion, a key economic cost of mandated third party access relates to pricing or allocative inefficiencies. All access regimes circumscribe the discretion of the access provider in the pricing and delivery of their services. The efficiency with which these terms are set is therefore a crucial aspect to the efficiency consequences of the proposed wholesale access regime.

4.2.1. Costs of wholesale products and logistics services

112. Determining the terms of access requires the regulator, at the very least, to establish the additional costs that the access seeker imposes on the access provider. These costs are almost always difficult to measure and require substantial information about the access provider's operations. When technology and market demands are changing rapidly, as is the case in grocery retailing, the difficulties for regulators are compounded. Again, there is a key point of distinction between price regulation as it typically occurs in the context of utilities, versus determining price and non-price conditions of access in the context of complex dynamic systems.

113. In the case of the wholesale access contemplated by the Commission, in my opinion, questions about what costs and prices should be charged to third party retailers are likely to arise at different stages of the supply chain. The most immediate relates to the costs of modifying WWNZ's existing systems and setting up new systems to handle the sale and/or logistics of supplying wholesale products to third party retailers, as well as the staff required to operate these systems. Given that these costs are a direct consequence of the proposed wholesale access arrangements, they should be attributed to third party retailers. Alternatively, if the government believes incurring these costs is in the public interest, it could finance them directly, which would have the benefit of transparency.

114. In my view, there are also material questions around how any 'wholesale price' for products would be determined:

- As noted at Para. 19, I understand that WWNZ attributes the cost of goods sold ('COGS') to retail stores, net of any rebates or discounts that WWNZ is able to negotiate. [] There is therefore no 'price' against which a non-discrimination obligation to supply third parties on "*terms that are in substance equivalent to those provided to its own retail businesses*" referenced by the Commission (Para. 9.49.4) can be assessed.
- [].
- I understand that, as is standard practice in New Zealand and internationally, WWNZ negotiates volume and other discounts (including promotional rebates) with suppliers which have a material effect on its overall COGS. Receiving these promotional rebates requires WWNZ to invest in and/or execute specific promotions and/or marketing activity in its retail stores. To ensure it fulfills those commitments, promotions are managed tightly throughout WWNZ's vertical chain, including in terms of timing, presentation, stock forecasting and ordering, advertising and pricing. Given their role as competitors, it is difficult to see how third party retailers could be included in such promotional activities. At the same time, passing on promotional rebates to third party retailers would enable these to 'free-ride' on WWNZ's promotional efforts, and WWNZ's suppliers' discretionary promotional investments.

115. There is additionally a question about the price that would be charged to third parties for any logistics services. While the 'cost to serve' varies across retail stores, WWNZ operates as an integrated entity and maintains nationally uniform retail pricing. I understand that WWNZ does not apply the type of activity-based costing approach that would be needed to accurately allocate

logistics costs to retail stores, and has not determined granular 'costs to serve' for either Countdown or franchise stores:

- Countdown stores are not allocated warehousing costs, but are allocated a percentage of weekly transport costs that is loosely based on the location of the store. This approach is unlikely to be sufficiently accurate for application to third parties.
- [].

116. It would be an error to regard the lack of a granular system of transfer prices which could serve as a basis for efficient decisions by third parties as a sign of managerial inefficiency. Rather, it is the flip side of the underlying efficiencies of vertical integration which make the price system a poor means of coordinating internal decision-making. As Professor Shyam Sunder explains in a well-regarded textbook on the economic foundations of management information systems (p.45):²⁷

The transfer pricing problem is often stated in a manner that ignores the circumstances that give rise to the problem in the first place... Integration of the two divisions into a single firm is predicated on the cost of market exchanges between them being greater than the administrative and agency costs. After integrating two divisions under this rationale, one cannot then turn around and wish the administrative and agency costs away through an appeal to a costless but non-existent system of market exchange.

117. Third party access would, however, require such a price system to be developed. It is, for example, clear that in a third party access scenario, uniform or 'approximate' delivery charges would no longer be viable; in effect, WWNZ would be subsidising some third party stores and penalising others. Moreover, such averaged charging would distort the entrant's locational decisions, and encourage 'cherry-picking' – in which an access seeker used WWNZ's delivery service where the average price was below attributable cost, and contracted directly with third parties elsewhere—undermining efficiency.

118. One of the consequences of access would therefore be the need to establish a differentiated charging framework that, among other things, accurately reflected storage, locational and picking costs.²⁸ In my view, determining such differentiated charges would be a significant and complex undertaking, given that products destined for third party retailers would likely be handled and transported jointly with those distributed to WWNZ stores. In circumstances where there are joint costs, determining what share of costs should be attributed to which party becomes a very difficult and contentious problem to solve. Indeed, given the combination of joint costs and lumpiness in capacity, a set of charges which would encourage efficient usage decisions may well not exist.²⁹ As Professors William Baumol, Michael Koehn and Robert Willig famously put it in discussing cost allocation and the definition of third party access charges in the presence of pervasive cost jointness:³⁰

²⁷ Sunder, Shyam, 1997. *The Theory of Accounting and Control*, South-Western College Publishing, Cincinnati Ohio, p.45.

²⁸ 'Picking costs' refer to the costs associated with 'picking' products inside the DC and putting these into trucks for distribution to stores. These costs would differ depending on the range, volumes, frequency and order sizes required by individual customers

²⁹ See for example, Quinet, E. 2003, 'Short Term Adjustments in Rail Activity: The Limited Role of Infrastructure Charges', *Transport Policy* 10(1): 73–9.

³⁰ Baumol, W.J., Koehn, M. and Robert Willig 1987, 'How Arbitrary is "Arbitrary"? -- or, Toward the Deserved Demise of Full Cost Allocation', *Public Utilities Fortnightly*, September 3, 1987.

Fully allocated cost figures simply have zero economic content. They cannot pretend to constitute approximations to anything. The “reasonableness” of the basis of allocation selected makes absolutely no difference except to the success of the advocates of the figures in deluding others (and possibly themselves) about the defensibility of the numbers.

119. Finally, even if such a set of charges were capable of being defined, any type of efficient charging system that would incorporate the costs of congestion or bottlenecks in the logistics network, for example during the Christmas peak, would likely be disputed by access seekers. I understand that managing congestion and bottlenecks in the logistics network is currently handled as part of WWNZ's integrated 'command and control' approach.

4.2.2. Opportunity costs of access

120. In my opinion, there are additional circumstances where regulatory determinations of price and non-price conditions of access for vertically integrated commercial businesses pose specific challenges. Particularly relevant in the current context is the loss of operational flexibility, which would give rise to opportunity costs for WWNZ. For instance, as I have described in Section 4.1, wholesale access is likely to reduce the efficiency of WWNZ's vertical supply chain, increasing logistics costs overall, including the costs of storing and distributing WWNZ's own merchandise.

121. In my experience, regulated pricing structures rarely reflect opportunity costs. Regulated access charges are instead typically determined on the basis of the 'building block' approach, that is, on the basis of some regulated return applied to a (historical) valuation of assets, depreciation and operating costs. There is little or no scope in practice to recover other costs imposed by access seekers, which may be as or more material than these 'regulated costs', including the costs of congestion and delays. However, if those costs are not fully and accurately reflected in the charging regime, access seekers will not have incentives to minimise them, instead imposing a negative externality on WWNZ and ultimately on consumers.

122. Contrary to what is typically assumed in declaration proceedings, it is also not the case in this instance that the regulator would have a well-tested, internationally recognised, methodology for determining 'efficient' access prices that would emulate a hypothetically efficient competitive outcome. While regulators have precedent and experience to draw on in setting prices for the services provided by facilities in the utilities sector, this is unambiguously not the case for vertically integrated and complex commercial facilities. In addition, regulated access prices are a poor tool for coordinating the shared use of complex facilities, making it likely that (inflexible) administrative rules and controls will be applied.³¹ Overall, the risk of regulatory errors with all the inefficiencies that would flow from these is considerable.

123. The issue of accounting for the access provider's opportunity costs is related to how investments that WWNZ may need to undertake in its logistics network to accommodate wholesale access are incorporated in the access terms and conditions. For instance, I understand that the capacity of some of WWNZ's DCs is already constrained in terms of the volume of throughput they can handle at certain times of the year, [].

124. Figure 4-1 shows annual capacity and forecast capacity requirements under a base, low, and high scenario, for the Auckland Regional DC (ARDC) and the Auckland National DC (ANDC), respectively. I understand that these projections form the basis for WWNZ's planned capacity investments, notwithstanding that wholesale access (let alone divestment) would make for a far

³¹ See Ergas (2009) and Ergas (2013).

more uncertain investment context. Annual capacity at the ANDC is expected to be exceeded [.] These capacity constraints are likely to become more acute if WWNZ were required to segregate products destined for third parties and, more generally, if wholesale access:

- reduces the efficiency with which the existing space at the DCs can be managed; or
- generates volume increases in excess of available capacity.

Figure 4-1. Capacity sensitivities at WWNZ's Auckland DCs

[]

Source: WWNZ, as of November 2021.

125. Examples of this type raise the question whether WWNZ would be obliged to invest in DC capacity (or in other aspects of its logistics network) to accommodate third party retailers, and how this should be reflected in access charges. More broadly, as I discuss in the following section, third party access is likely to change an access provider's incentives to invest and give rise to a range of inefficiencies.

4.3. DYNAMIC INEFFICIENCIES

126. In my opinion, a key concern with mandated access in grocery retailing relates to the incentives to invest in new capacity, technologies and processes, or to introduce new products, both on the part of the access provider and on the part of the access seeker.

127. For conventional utilities, facilities investment is generally an integral and predictable part of the regulatory process. Utilities invest to cater for changing demand conditions, and regulators typically monitor and approve investment plans. To the extent that these processes are followed by the regulated utility, assets are included in the 'regulatory asset base' where they will earn a reasonably predictable regulated rate of return.

128. Where commercial, privately owned facilities are concerned, there is of course no such guarantee that investors will see their funds returned. The commercial success of an investment in a specialised DC, for instance, depends on how consumer demand for certain types of products evolve (which in turn depends on product prices and consumer preferences), but also on how the network of stores that a DC is intended to service performs. There is consequently a level of risk in these investments, which third party access would exacerbate. This is particularly the case in a situation such as the present one where two competitors are confronted with a novel access requirement, further compounding the challenges and risks of poor outcomes. To make matters worse, third party access vests access seekers with a right but not an obligation to use the facilities of the access provider. This creates an asymmetry in the distribution of returns from an investment:

- the 'downside' is placed entirely on the access provider who would need to underwrite the long-term investment; while
- the 'upside' is shared with third parties.

129. As a result, the incentives on the part of the access provider to undertake significant investments, especially in facilities that are innovative or relatively risky, are reduced. By the same token, an access seeker assessing the trade-off of falling back on the essentially riskless option of regulated access versus undertaking an investment (that may in fact be better suited to their own entry or expansion plans) may elect to postpone or cancel such an investment. To the extent to which this occurs, society is worse off, as otherwise efficient, innovative investments are unnecessarily deferred or even entirely foregone.
130. Given that the aim of the Commission is to increase competition in retail grocery, it is relevant that third party access will affect investment incentives, not just on the part of the access provider, but also for access seekers. From the perspective of the access provider, all things equal, third party access will reduce the earnings from a facility such as a DC. From the perspective of the access seeker, the ability to access existing infrastructure under regulated terms *prima facie* reduces the incentives to invest in the wholesale and logistics infrastructure that are an integral part of grocery retailing today. Moreover, the greater the extent to which the terms and conditions of access favour entry by lowering the costs and risks access seekers must bear, the greater will be the incentive for access seekers to invest in lobbying for continued 'infant industry' protection. In my experience, regulators, like governments indulging in 'infant industry' protection, have found it difficult, if not impossible, to credibly commit to dismantling entry assistance, resulting in an outcome in which sustainable, head-to-head competition does not emerge. It is therefore difficult to see how wholesale access can improve the prospect of genuine competition.
131. A related issue is the incentive to innovate, for instance, in terms of changing processes within the vertical wholesale – retail relationship. Under a third party access arrangement, such changes may require access seeker and/or regulatory approval and will therefore be more difficult to implement, as well as potentially raising questions about commercial confidentiality and the ability of access seekers to 'free-ride'.
132. One example that is relevant here is the process that WWNZ goes through in terms of identifying and testing promising innovations. I understand that, like other grocery retailers internationally, WWNZ may invest in proof of concept (POC) processes in which pilots are conducted to test customers' responses to retail initiatives, for instance, private label products, expanded ranges of refrigerated health foods products, or dedicated coffee pod sections in aisles. Innovations, such as new product offerings that are found to be successful are included in WWNZ's retail offering. Under wholesale access, these products would presumably also be available to third party retailers who have not invested any corresponding efforts and resources. In my opinion, this scenario exemplifies instances where third party retailers would effectively 'free ride' on the efforts of the access provider, with little or no risk or cost to themselves.
133. More generally, mandated access would increase the costs, and reduce the incentives, for WWNZ to constantly refresh, as it now does, the range of SKUs it carries. To begin with, operational or structural separation would make the process of introducing new goods more complex, and hence costly, not least because any changes would presumably have to be approved (or at least accepted) by access seekers. This would slow the process and reduce the incentive to make changes in line with rapidly evolving consumer tastes (as discussed in Paras. 62). Second, because the access seeker would share in the benefits of the changes – indeed, might be able to 'free ride' on the costs involved in testing and contracting for them – WWNZ's return on innovation would decline, reducing the profit-maximising rate of product line renewal. Given consumers' growing demand for variety, the result would be to harm consumers and reduce overall efficiency.

134. The adverse impacts on product innovation would be made all the greater by mandated separation. In my opinion, in such a scenario, the link between customers and the wholesale buying function would be broken, and a significant share of the information flows and coordination between functions that characterise a vertically integrated organisation would be lost. In the current model, range reviews are undertaken on a regular basis. In the separation model, there would presumably be some form of range review occurring at the retailer level, but it would be more difficult to enact change because that would require 'arm's length' coordination with the wholesale business unit (BU). Moreover, the wholesale BU would need to coordinate with both its affiliated retail entity and with any third party retailers, and ensure it had the relevant approvals for a change in product range. Finally, the wholesale BU would need to design, negotiate and implement the relevant contracts with suppliers, obtaining their approval too, notably for supply to third parties. At a minimum this process would add delays and transaction costs to the range review process. And in some instances, the process would 'fail', for example, if the required approvals from third party retailers were not forthcoming. To that extent, the number of range reviews would be likely to diminish, which in turn would reduce turnover in the number of SKUs and reduce the match between consumer preferences and ranging decisions.
135. While these impacts are necessarily hard to demonstrate – given that there are no precedents for the proposals the Commission has advanced – the experience in telecommunications is relevant (albeit not analogous to grocery retailing for the reasons noted). Thus, in Australia, operational separation required Telstra to retain obsolete services – notably for copper continuity services and for certain ISDN basic rate products – because a small number of access seekers refused to bear the costs of moving their offerings to new product lines. This imposed additional maintenance costs and slowed the overall process of network modernisation. It hardly needs to be said that in grocery, where the number of distinct products is orders of magnitude larger than in telecommunications, and where the turnover of product lines is virtually continuous, the risk of such unintended consequences is likely to be much greater.

4.4. DISPUTE COSTS AND STRATEGIC BEHAVIOUR

136. Mandated third-party access redistributes income between market participants – most obviously between the access provider (whose shareholders will generally lose from the mandated access requirement) and access seekers who, at least in the short run, can hope to gain. The scope for such redistribution can create formidable incentives for 'rent seeking': securing for oneself a larger share of any economic 'rents' that may be available. Rent seeking absorbs resources that could have been put to productive use elsewhere, and amounts to a pure waste of society's scarce resources. Moreover, economic theory predicts that rent seeking can waste at least as much in resources as the available rents, as competition for the rents converts them into resource costs.
137. Costs arising from 'strategic behaviour' arise because the parties to an access agreement have conflicting interests, and have incentives to manipulate processes to their own advantage. These incentives are likely to be greater for third parties who would likely account for only a small share of any wholesale products, and for whom there is correspondingly little downside, for instance by entering into disputes or invoking arbitration provisions. In my opinion, this is a plausible scenario in the current context where the major retailers may need to accommodate a number of (would-be) retailers, who would stand to lose little by disputing the terms of access.

138. In my opinion, the scope for strategic behaviour is compounded by the apparent intention of the Commission to place wholesale access obligations on both the two major retailers.³² Such an approach would in turn raise the question which party would bear the obligations, and whether access seekers would be required to enter into long-term commitments, or could play off the access providers against one another. In other words, in public utilities, the natural monopoly feature of the upstream makes regulation much easier, as it reduces the range of possible transactions.
139. All of these actions would pose a greater commercial risk to a (vertically integrated) access provider, whose own requirements would likely form the significant majority of the use of any existing capacity. Hence the facility owner may have little choice but to invest anyway, or to accept less than cost-reflective tariffs in order to protect its own business interests, strengthening the incentives for strategic behaviour by access seekers even further.
140. To that extent, market outcomes will be distorted, even in the short run. Not only will the access seeker be advantaged by its rent-seeking behaviour, so too will be Foodstuffs NI/SI (assuming the obligation falls on WWNZ, or vice-versa were the obligation placed on Foodstuffs NI/SI). Output will thus be diverted, at least potentially, from more efficient to less efficient suppliers, imposing an immediate resource cost on New Zealand's economy. Over the longer term, the rent seeking will reduce overall output as rents are converted into excess costs, compounding the damage. Prices would be higher, not lower, harming consumers.

4.5. IMPLICATIONS OF THE COMMISSION'S REGULATORY OPTIONS

141. The Commission has not set out the scope of the wholesale access arrangements that it has in mind, but has outlined various access regimes that differ in terms of their intrusiveness and complexity. As I set out in the following, in my opinion, implementing any of these regimes would be costly in its own right, but would also give rise to potentially very significant efficiency losses. Ultimately, these lost efficiencies are likely to result in increases in the costs of grocery retail products that would harm consumers.
142. A broad range of approaches are used internationally in access regulation, with commonalities and differences between them. As the Commission has not spelled out the approach it would adopt, I consider first enforceable access undertakings and then the economic regulation of access, recognising that there can be a considerable degree of overlap between them. After that, I turn to consider separation options.

4.5.1. Enforceable access undertakings

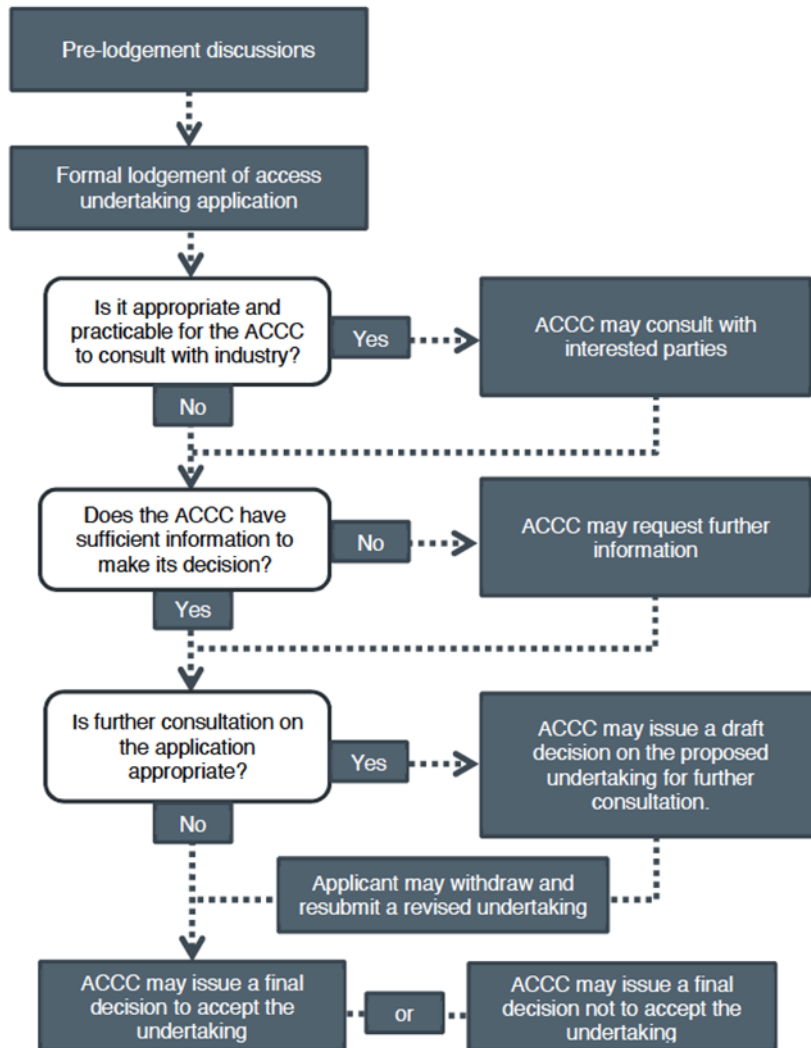
143. 'Enforceable undertakings' have played an important role in Australia where they are applied in different contexts, both at the Commonwealth and at the state level.³³ They are 'promises' by an individual or a firm, enforceable in court, that the relevant regulator may elect to 'accept'. Regulators such as the ACCC generally set out a brief description of the type of terms they do and do not expect to be included in enforceable undertakings, and how they expect to use these instruments. Where access undertakings are concerned, the ACCC has established a formal process that requires the access provider to lodge an undertaking (Figure 4-2). An access undertaking must be

³² The Commission is silent on the question as to whether such an obligation would also be placed on future entrants, such as Costco, which is planning to open its first store in Auckland in 2022.

³³ Johnstone, R. and Parker, C., 2010. Enforceable undertakings in action: Report of a roundtable discussion with Australian regulators. Available at SSRN 1551627.

'accepted' by the ACCC to come into force. After a period of pre-lodgement consultation, the ACCC has 180 days to decide to accept an undertaking. Third parties may make submissions on the acceptability of the terms of the undertaking, and the ACCC may 'stop the clock' and request further information from the access provider.

Figure 4-2. Potential stages of an ACCC access undertaking assessment process



Source: ACCC 2016, p.14f.

144. While there is scope for negotiations, key aspects of such an undertaking tend to be subject to regulatory scrutiny and are predetermined. At least in the Australian context, the access undertaking must contain certain minimum provisions, including:³⁴

- the scope and nature of services that would be provided;
- the duration of the undertaking;
- the pre-conditions for access (such as prudential requirements) that access seekers would need to satisfy;

³⁴ Australian Competition & Consumer Commission, 2016. Part IIIA access undertaking guidelines, August.

- the processes for obtaining access, including a standard-form access contract (intended as a transparent starting point for negotiations), provisions governing the negotiation process, the information to be shared in that negotiation, and the process for resolving disputes;
- rules or principles governing how access prices will be structured and set;
- in the event the access provider has limited capacity, rules regarding the allocation of capacity;
- rules governing how investment decisions will be made and costs recovered, including extension or expansion investments necessary to facilitate access;
- rules governing on-going interaction between the access provider and access seekers;
- provisions to ensure the access provider has incentives for cost efficiency, service quality, and innovation, and that access seekers have transparency about the access provider's performance;
- measures to address concerns about a vertically integrated access provider discriminating in favour of its own related business compared with upstream or downstream competitors; and
- provisions to allow for effective regulatory oversight of the access provider's compliance with the undertaking.

145. As I have discussed in Section 4.4 above, in my opinion the process of reaching agreement on an access undertaking in itself is likely to be prone to disputes, in particular given that would-be access seekers are likely to see an opportunity to 'set in stone' favourable terms and conditions for themselves.

146. If mandated access undertakings were implemented, I would expect that WWNZ would be obliged to establish a third party wholesale function that would likely need to incorporate some or all of the provisions listed in Para. 144, a number of which would likely prove onerous – for instance, the need to:

- put in place dedicated processes for dealing with access seekers;
- inform access seekers about WWNZ's 'performance' using different metrics;
- demonstrate that WWNZ is not 'discriminating' in favour of its own retail operation; and
- put in place an ongoing regulatory reporting framework.

147. WWNZ would also need to invest in the requisite systems and staffing, with little assurance that these outlays could be recouped.

148. Furthermore, as I have outlined in Section 4.1, it is difficult to see how any form of mandated access would not impose potentially significant opportunity costs on major retailers such as WWNZ whose supply chains, including the corresponding internal systems, are vertically coordinated to minimise operational costs and facilitate ongoing product innovation. If the Commission's approach in relation to undertakings were to follow that of the ACCC, I would expect that such costs would, at a minimum, arise in the context of a loss of flexibility arising from:

- a commitment to maintain access prices or pricing structures for the duration of the undertaking;
- an obligation to make available a share of existing capacity to access seekers, and to commit to a methodology for doing so;

- an obligation to consult with access seekers in relation to any investment (or other material change in its operations) that may be required and to obtain agreement from access seekers; and
- some degree of internal ring-fencing to demonstrate that WWNZ is not offering more favourable terms to its own retail operations.

149. To take but one example, a requirement on WWNZ to segregate or 'reserve' space in its DCs would be costly. As I discuss at Para. 102, segregated inventories would require WWNZ to reorganise its processes for picking and assembling goods within the DCs, and would cut down on storage capacity.

4.5.2. Economic regulation of access

150. I would expect that the economic regulation of access would standardise the access obligations of the major retailers beyond what might be the case in an access undertaking. In my opinion, the economic regulation of access would therefore represent a more intrusive and costly intervention. To the extent that this option further reduces WWNZ's flexibility in managing its supply chain, operational inefficiencies can be expected to become even more material.

151. In my experience, regulated access involves regulatory determinations and ongoing oversight of access terms over many years, often in a dispute-prone context. The associated information and implementation costs tend to be greater the more complex, diverse and/or extensive the activity is that is being controlled. Above and beyond the requirements associated with enforceable access undertakings, mandated access regime whereby the terms and conditions of access are approved or set by a regulator typically requires:

- the analysis of detailed information about the access provider's business, including assets, operational and investment costings, and demand forecasts;
- determining the returns that the access provider is allowed to earn on assets deployed, which in turn requires selecting a valuation methodology and depreciation schedule, determining an appropriate regulated rate of return, and valuing the assets accordingly;
- considering operating cost and asset utilisation outcomes and forecasts to determine what constitute the access provider's 'efficient' operating and capital expenditure costs going forward;
- setting a particular charging structure for access seekers to enable the access provider to recover efficient costs;
- determining quality standards for the services that the access provider must provide; and
- devising dispute resolution mechanisms to resolve disputes between access seekers and the access provider.

152. These decisions require significant data and analysis to arrive at a ruling and are generally contentious. Access seekers will request a lower asset valuation and a rate of return than that sought by the access provider. The different parties will almost certainly have differing views on what constitutes 'efficient' costs. The design of access charges is also a complex topic, including because:

- the preferences of different access seekers for various charging structures are generally not aligned; and

- the regulator may ‘set in stone’ access charges that are no longer efficient or cost-reflective when circumstances change.

153. The Commission states that, at this stage of its study, it does not consider (Para. 9.50) “*direct regulation of wholesale pricing to be desirable*”. However, it is difficult to see how price regulation could possibly be avoided. Rather, in my opinion, the Commission would inevitably be thrust into a role as a price regulator because disputes would arise both as to the reasonableness or otherwise of the access provider’s charges and as to whether those charges were ‘equivalent’ to the charges the access provider ‘charges’ itself. I therefore believe the Commission would become a price regulator, with all the inefficiencies that involves.
154. Furthermore, the apparent suggestion that staff of the ‘wholesale business’ should be separated from that of the ‘retail business’ and the prohibition on sharing information (Para. 9.49.3) implies that what the Commission refers to as ‘economic regulation of access’ would effectively imply at least a degree of organisational separation.³⁵ Such a requirement would prevent WWNZ from taking into consideration operational and planning interdependencies, with the associated inefficiencies that this would entail.
155. The resolution of disputes by the regulator, finally, gives the access seeker a ‘free’ option to appeal an access provider’s decision so that many disputes must then be resolved by a regulator, rather than by the parties to the access agreement.
156. All of these difficulties will, in my opinion, be compounded in an industry which has never been subjected to regulation of this type, and where there is no expertise whatsoever as to how access regulation would be implemented.

4.5.3. Operational separation

157. Operational separation requires changing a firm’s underlying business practices, with the aim of segregating assets or other inputs within a separate business unit (BU) that deals with third party access.³⁶ Operational separation involves many decisions about the firm’s internal reporting structure (governance), who is permitted to talk to whom and about what topics (information walls), what systems can be shared across BUs (e.g., operational and support systems), as well as remuneration (management incentives).
158. The exceptional nature of this remedy, in particular the fact that it is a costly, complex and intrusive measure, is reflected in the legal provisions that deal with operational separation in other jurisdictions. Thus the legal provisions of Article 13a of the EU Access Directive (as revised) states that:³⁷

*Where the national regulatory authority concludes that the appropriate obligations imposed under Articles 9 to 13 have failed to achieve effective competition and that there are important and persisting competition problems and/or market failures identified in relation to the wholesale provision of certain access product markets, it may, **as an exceptional***

³⁵ I comment on the implications of organisational separation in more depth in Section 4.5.3 below.

³⁶ The terms ‘operational’ and ‘functional’ separation are often used interchangeably, although – in theory – functional separation involves requirements above and beyond those entailed by operational separation alone. See also: Body of European Regulators for Electronic Communications, 2011. BEREC Guidance on functional separation under Articles 13a and 13b of the revised Access Directive and national experiences, February.

³⁷ Directive 2009/140/EC of the European Parliament and of the Council of 25 November 2009.

measure [...] impose an obligation on vertically integrated undertakings to place activities related to the wholesale provision of relevant access products in an independently operating business entity (emphasis added).

159. In my experience, operational separation would require WWNZ to establish a dedicated wholesale BU with separate systems and management that would be:
- dedicated to solely providing wholesale access (however such access would be defined) to third parties; and
 - subject to a wide range of ‘information walls’ and reporting requirements aimed at ensuring ‘equivalence’, (i.e. non-discrimination in the price and non-price terms and conditions of service as between internal and third party customers).
160. Box 4-2 provides an overview of the implications of ‘operational separation’ as it was applied to Telstra (the Australian telecommunications provider that had previously been vertically integrated). In my opinion, the difficulties encountered in operationally separating Telstra are relevant here, although retail grocery would present an exponentially more complex challenge, given that stocking decisions change every day and given the added complexities of multiple third party contracts with suppliers.
161. Box 4-2 highlights that in the case of Telstra, operational separation involved a broad range of requirements about the ring-fencing of staff and information, and the assurance of service and price ‘equivalence’ between internal and external customers (i.e., that ‘internal’ and ‘external’ service quality and prices had to be aligned). It is relevant that the regime initially only applied to a relatively small range of inter-related services (almost all of which were legacy services). Under pressure from access seekers, it was expanded to cover ever more services, increasingly creating pricing distortions. It also proved extremely difficult for Telstra to withdraw services when they became obsolete, because some (often only a very few) access seekers depended on them. In my opinion, these are important parallels that apply with even greater force in retail grocery, given the range of products and/or services that ‘wholesale access’ could encompass and the turnover in SKUs (Box 3-1).

Box 4-2. Telstra’s ‘Operational Separation Plan’

Telstra was required under the Telecommunications Act 1997 to prepare for approval by the Minister draft Operational Separation Plan (OSP). The OSP committed Telstra to create and operate:

- a Retail BU in a manner that was substantially separate from the Wholesale BU and a ‘Key Network Services’ BU; respectively, and similarly,
- a Wholesale BU and a Key Network Services BU that were also substantially separate from each other and from the Retail BU.

The role of the Wholesale BU was to:

- market Eligible Services to wholesale customers;
- manage service delivery to wholesale customers; and
- negotiate supply contracts with wholesale customers.

Restrictions were placed on the extent to which (if at all) Telstra employees could work across different BUs. Staff of the Wholesale BU needed to be located in premises physically separate from the Retail BU, with associated security measures to prevent access by Retail BU staff (unless specifically authorised). ‘Notional contracts’ were to be established governing the supply of certain services between the Key Network Services BU, the Wholesale BU, and the Retail BU.

Telstra was required to prepare and lodge with the Minister and the ACCC various strategies:

- a Service Quality Strategy, to ensure that wholesale customers would receive an equivalent level of service as the Retail BU;
- an Information Equivalence Strategy, to demonstrate that information provided to wholesale customers was, to the extent possible, equivalent to the information provided to the Retail BU;
- an Information Security Strategy, to protect confidential information relating to Telstra's wholesale customers; and
- a Customer Responsiveness Strategy, to ensure that Telstra would be responsive to wholesale customer complaints, to establish a process for resolving disputes, and to describe measures implemented to monitor compliance with the above strategies.

Telstra was further obligated to establish a 'price equivalence framework' in order to, among other things, demonstrate that prices charged to wholesalers were 'legitimate', when compared to those charged to its Retail BU. That price equivalence framework incorporated a number of principles approved by the Department and the ACCC.

Telstra agreed to meet its compliance and reporting requirements via a committee appointed by the Telstra Board that oversaw the activities of the 'Director of Equivalence'. An independent external auditor had to be appointed each financial year to prepare a compliance report. As a general rule, Telstra was also required to respond to any information request made by the ACCC.

Source: Telstra, 2006. Operational Separation Plan; at: <https://www.accc.gov.au/regulated-infrastructure/communications/industry-reform/operational-separation-of-telstra/operational-separation-framework>; accessed on 1 November 2021.

162. In my opinion, the types of obligations placed on Telstra point to the potentially very significant ongoing costs and lost efficiencies that arise if (efficient) vertically integrated businesses are forced into operational separation. These lost efficiencies arose, for instance, from the requirement for separate functional BUs (underpinned by 'notional contacts'), thus greatly limiting (if not eliminating) the scope for flexible coordination between different functions. Further, the requirement to demonstrate 'equivalence' using various 'KPIs' across a range of services (such as billing and complaint management, new product development and introduction, and on pricing) proved to be very difficult to implement, resulting in a considerable 'regulatory creep' in the form of more intrusive and costly regulation.

163. How operational separation in grocery retailing could then be expected to work in practice is not clear to me. As I have described at Paras. 66ff., information flows and operational and longer-term decisions between WWNZ's different functions are closely intertwined and interdependent. Thus, in my opinion, operational separation in retail grocery would potentially eliminate:

- the ability of the 'wholesale' BU to consult with the 'retail' BU on matters, such as:
 - the ranging of products;
 - the introduction of new products;
 - product pricing and marketing strategies; or
 - operating and capital expenditures on wholesale services or infrastructure; and equally,
- the ability of the 'retail BU' to consult with the 'wholesale' BU on such matters as:
 - the introduction of new retail products or new retail services;
 - retail pricing; as well as
 - operating and capital expenditures on retail services or infrastructure.

164. These types of intra-firm consultations take place on a regular basis; if they were prevented from occurring, the result would, in my opinion, be a less consumer-oriented organisation whose costs overall would rise. In addition, I would also expect potentially significant disruptions and disputes in dealing with out-of-the-ordinary events, including those listed in Box 4-1, namely the current pandemic, natural disasters such as earthquakes and floods, or any other unexpected event (such as a fire or breakdown at a DC).

4.5.4. Structural separation

165. Under full structural separation, a firm is split into one or more businesses providing wholesale access to third parties and retail services with separate management and potentially under separate ownership.³⁸ Structural separation would involve different governance and/or different remuneration arrangements, so that incentives would no longer be set on the basis of the overall firm's performance.

166. Structural separation of the major retailers' wholesale and the retail business divisions would represent an extraordinary market intervention. In my opinion, structural separation would eliminate all of the gains from vertical integration that have made this the preeminent business model in grocery retailing globally across many competitive contexts; namely the need for retail grocery businesses (Para. 76):

- to be able to coordinate their downstream and upstream operations to minimise operational and logistics costs on an ongoing basis; and
- to be sufficiently nimble across all parts of the organisation to cater to changing consumer preferences and expectations, including in terms of the types and range of products supplied, shopping and delivery options, as well as many future innovations that are as yet unknown.

167. In other words, structural separation would entirely remove the ability of a vertically integrated business such as WWNZ to overcome 'vertical externalities' (Para. 60) whereby the incentives of different functional layers are not necessarily aligned. In my opinion, structural separation would primarily hurt consumers, for whom the costs of delivered goods would rise, and who would be presented with an outdated and unresponsive retail business model. Moreover, returning to a business model which the grocery sector has largely abandoned worldwide would expose consumers unnecessarily to the consequences of unexpected events that threaten the grocery supply chain, such as earthquakes and floods or a future pandemic.

4.5.5. Costs of the Commission's regulatory options

168. The Commission has not set out the scope of the wholesale access arrangements that it has in mind, but has outlined various access regimes of increasing intrusiveness and complexity. In my opinion, the costs and sources of inefficiencies I have described arise in all of the mandated options that the Commission is considering, from undertakings to structural separation, and increase the further those options 'reach' into and disrupt WWNZ's vertically integrated operations.

169. In my opinion, all of the options for mandated wholesale access imply significant direct costs of regulation, in terms of new systems that must be put in place by the access provider(s) and the associated staffing, the organisational changes that must be made, and the costs of complying with access regulation (which include the cost of in-house management resources, and external

³⁸ Cave, M. and Doyle, C., 2007. Network separation and investment incentives in telecommunications. Paper for eircom.

specialist legal/economic advice). The direct costs of regulation additionally include the costs of funding the relevant regulatory agencies, including to undertake their rule making, dispute resolution and monitoring functions. These costs are likely to be all the greater given that they would be incurred in an industry which has never been subjected to regulation of this type.

170. In my opinion, the more material costs are likely to be the indirect costs of (access) regulation, including on consumers. These are the economic costs I have discussed throughout this report: the unintended inefficiencies regulation brings with it, including the harm caused by settling inappropriate terms and conditions of access, operational inefficiencies that are introduced as a result of third party access, and the disincentives third party access creates for investment and innovation.

5. COSTS OF WHOLESALE ACCESS VS COMPETITION BENEFITS

171. As I have described in this report, in my opinion, the Commission's proposals would give rise to a range of short- and longer term inefficiencies that would also harm consumers. In this section I argue that the Commission has not properly considered the trade-offs between enabling greater competition, on the one hand, and the costs of achieving that competition, on the other.

5.1. INEFFICIENCIES ARISING FROM WHOLESALE ACCESS

172. The purpose of the *Commerce Act 1986* ('the Act'), which is administered by the Commission, is to promote competition in markets for the long-term benefit of New Zealand consumers. However, the Act also clarifies that in promoting competition, the Commission must take into account other objectives, namely efficiency considerations. That requirement is referenced, for example, in Part 4, which specifies that, in undertaking an enquiry into goods or services that may be regulated, the Commission must (S521(2)(b)) "*undertake a qualitative analysis of all material long-term efficiency and distributional considerations*" and, (S521(3)(a)) "as far as practicable" ... "*quantify material effects on allocative, productive, and dynamic efficiency*".

173. The potential efficiency losses of its wholesale access proposals for the major retailers are not discussed in the Commission's Draft Report, and I understand that they were not explored in any detail at the consultation conference. The Commission may assume that such losses are small so that they would be outweighed by the competition benefits of its proposals, and that over time, those losses would disappear as the entrants moved off third party access. In my opinion, in contrast, mandated wholesale access in any form would give rise to significant costs and inefficiencies. Furthermore, as I explain below, there are good reasons for thinking that any competition benefits that might arise as a result of implementing the Commission's proposals would not outweigh these costs.

5.2. LIKELY NATURE OF COMPETITION

174. In my opinion, any competition benefits from the Commission's proposals will be diminished by the fact that any entrant will, to a greater or lesser extent, be a copy of the incumbents, and the greater the extent of entry facilitation, the less differentiated it will be:

- Access seekers sourcing their wholesale products from the major retailers would essentially compete for customers on the basis of substantially the same cost to serve. They would, moreover, compete for customers on the basis of the same product range and quality as that offered by the major retailers.

- It therefore seems unlikely that wholesale access would enable vigorous price competition, as for example pursued by Aldi and Costco (both of whom rely on their own supply chains). Indeed, the presence of these assisted entrants may make entry or expansion by such fully integrated firms, which could offer head-to-head competition, more risky and less likely.

175. In my opinion, the Commission's focus on access to wholesale products also overlooks other, less tangible aspects of grocery retailing. As I have set out in Para. 74, customers are increasingly demanding a range of value added services that relate to convenience and speed, such as specialised apps, innovative store formats, e-commerce, and a range of delivery options. To the extent to which customers value these and as yet unknown innovations, third party retailers that do not develop a distinct value proposition would be unlikely to epitomise effective competitors.
176. In my view, the most likely outcome of wholesale access would therefore be a version of intra-brand competition, with the access seekers' grocery operations largely resembling repackaged 'clones' of existing WWNZ and Foodstuffs retail outlets. Such competitors would fall well short of the kind of constraint imposed by the likes of Aldi and Costco. These competitors enter as fully vertically integrated entities with established supply relationships and a broad range of private label brands. While they typically enter markets on a small scale, they scale up substantially, imposing an ever more effective competitive constraint. Yet paradoxically, by crowding what is a relatively small market, wholesale access might deter or postpone the entry and growth of these full-blown competitors.³⁹
177. The experience of Aldi's entry into the Australian grocery market is instructive. Aldi entered the Australian grocery market in 2001 and today operates more than 570 stores in six states and territories, directly employing more than 13,500 people and working with more than 1,000 Australian business partners each day.⁴⁰ The ACCC (2008) found that Aldi had made a positive contribution to price competition in the Australian grocery market. The ACCC found that (p.169): "*ALDI competes effectively with the MSCs on price. ALDI's effect on the pricing of the MSCs is significant for the products that the MSCs consider are most comparable to those offered by ALDI. These are primarily private label products.*"
178. Both economic analysis and commercial experience suggest that the opportunity cost of deterring or slowing head-to-head entry for the sake of promoting assisted entry would be high. Bearing, or taking the risk of bearing, those costs seems all the more unnecessary given that Costco has already confirmed its entry into the New Zealand market and that Aldi may well enter it in future.
179. Nor should the Commission simply assume that assisted entry will result in vigorous price competition and lower consumer prices. As things now stand, WWNZ's Countdown business secures the full 'business stealing' benefit of any price reductions it initiates. However, equivalence rules, as they have invariably been interpreted, would require it to make a corresponding reduction in the wholesale price charged to access seekers. (This is, for example, the mechanical effect of conventional imputation tests, which define the wholesale price that is to be set to third parties as the integrated entity's retail price minus a fixed margin.) As a result, the incentive for price

³⁹ Further, the possibility that the Commission might impose similar mandatory 'access' obligations on ALDI/Costco as vertically integrated grocery industry players, would in my opinion constitute a substantial deterrent to any entry or expansion in the retail grocery sector.

⁴⁰ [https://corporate.aldi.com.au/en/about-aldi/#:~:text=ALDI%20Australia%20operates%20more%20than,Australian%20business%20partners%20each%20day](https://corporate.aldi.com.au/en/about-aldi/#:~:text=ALDI%20Australia%20operates%20more%20than,Australian%20business%20partners%20each%20day;); accessed 1 November 2021.

competition will be reduced, with WWNZ instead providing a 'price umbrella' under which the entrant can shelter.

180. The adverse impacts on prices would obviously be even greater under functional or structural separation. Assuming, as seems likely, that wholesale charges would, in that event, be set on the basis of average costs, there is almost certain to be double marginalisation – that is, the retail layer would further mark-up the already marked-up prices it was charged by the wholesale layer. As is well known, that can lead to consumer prices even exceeding those which would be charged by a vertically integrated monopolist.
181. Before proceeding along the path it has outlined, the Commission ought therefore to carefully consider whether it will actually yield the benefits it seeks, and define the approach it would adopt to ensure costly policy failures were not allowed to occur and persist, as so often happens.

5.3. LONG-TERM INVESTMENT RISKS FOR NZ

182. My concern about crowding out genuine entrants and competitors in the New Zealand retail market also relates to the radical nature of the Commission's proposals. In contrast to the conventional public utilities, in which the bulk of costs were incurred long ago (and only require gradual renewal), grocery retailing requires high levels of ongoing investment.
183. However, in my view, a decision to impose a regime such as that proposed by the Commission would greatly increase the perceived riskiness of investment, especially foreign investment – both in this industry and more generally in New Zealand. In particular, current and future entrants and competitors are likely to take note of what is a very significant intervention in the market. Enormous care therefore needs to be exercised before floating, much less taking forward, proposals of that kind.
184. In closing, it is worth noting the relevance of the conclusions of the Independent Committee of Inquiry on National Competition Policy, which was established by then Australian Prime Minister Paul Keating, reached in its landmark report.⁴¹
185. The Report found that third party access should apply to facilities and industries in which government had traditionally been involved (major infrastructure facilities such as electricity transmission grids, major gas pipelines, major rail-beds and ports), but *not* to "products, production processes or most other commercial facilities".⁴² Furthermore (p.242):

As a general rule, the law imposes no duty on one firm to do business with another. The efficient operation of a market economy relies on the general freedom of an owner of property and/or supplier of services to choose when and with whom to conduct business dealings and on what terms and conditions. This is an important and fundamental principle based on notions of private property and freedom to contract, and one not to be disturbed lightly.

186. The Report further set out (p.251):

Moreover, when considering the declaration of an access right to facilities, any assessments of the public interest would need to place special emphasis on the need to ensure access

⁴¹ National Competition Policy, Report by the Independent Committee of Inquiry, August 1993.

⁴² Report by the Independent Committee of Inquiry, Page 251.

rights did not undermine the viability of long-term investment decisions, and hence risk deterring future investment in important infrastructure projects.

187. Similarly, in the United States, where the “essential facilities doctrine” originated, the Supreme Court has scaled back its reach, both as a result of practical experience and under the influence of the highly influential notes of caution expressed by the late Professor Phillip Areeda, of Harvard Law School. Reviewing the history and implementation of the doctrine in 1989, Professor Areeda warned of the dangers of not stringently restraining its scope. He argued that:

- Compulsory access, if it exists at all, is and should be very exceptional; and
- A facility should be recognised as “essential” only when it is both critical to the plaintiff’s (i.e. access seeker’s) “competitive vitality” and the plaintiff is essential for competition in the marketplace, meaning that the plaintiff cannot compete effectively without it and that duplication or practical alternatives are not available (Areeda, 1989).

188. In the light of those warnings, and of the myriad risks highlighted above, a careful, properly documented, appraisal of the costs and benefits of regulated access is therefore required before so unprecedented a proposal as that advanced by the Commission is allowed to proceed.

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