DAY 6 - RETAIL GROCERY MARKET STUDY CONFERENCE

1 November 2021

Session 9: Divestment and sponsorship of entry

Ms Rawlings: Morena, kia ora tatou, good morning, welcome back to the second to last day of the Commerce Commission's conference to consult on our draft report into our market study on the grocery sector. Welcome to those joining the conference for the first time today, I think there's just one or two people. I'm Anna Rawlings, the Chair of the Commerce Commission for those who haven't met me before.

We're now pretty familiar with the session process, but because we've got a couple of new people today I'll just quickly run through a few of those logistical matters and then we'll maximise our time for discussion today.

Today's sessions are going to cover operational and structural separation as a means of facilitating entry and expansion and we address these matters in our draft report in our options for recommendations and they assume those matters that have gone before last week and most of you, hopefully, will be familiar with the discussion in our draft report.

Again with me today are familiar faces, Commissioners who have been working on the grocery market study, they are Dr John Small, Dr Derek Johnston and Associate Commissioner Vhari McWha. A number of Commission staff are also here again assisting us with the conference and with our study both online and in our room in Wellington.

So far in the conference we've discussed the Commission's identification and assessment of factors affecting competition in this sector. And we've also discussed some of the options that we identified for recommendations for improving competition if we ultimately consider that competition isn't working as well as we think that it should in our final analysis and in our final report. Both the conference and comments are by way of written submission to date but also submissions that we receive after the conference and discussions that we have in the next few weeks are all important to helping us to finalise our findings and our recommendations.

Today's session will run again until 10.45 and then we'll break for a 30-minute break in mid-morning and we'll resume at 11.15, scheduled to finish at 12.30 today.

Tomorrow's sessions have been earmarked as an overflow for anything that we didn't get to and we may use that for some of the material we wanted to cover today if we don't get to it today. And we'll also circle back tomorrow to discuss matters relating to strategic barriers to entry or wholesale access, so we will have a session of a similar form tomorrow morning and that will be the final session. It will also include an opportunity for some final closing comments by those major parties that we've heard from throughout the conference.

I want to remind everyone of course that despite this additional time, it's not the final opportunity for us to hear from you and we've asked for submissions on matters arising out of the conference, or new matters arising in the submissions of others, by the 23rd of November and we'd encourage you to take advantage of that opportunity. And we may also have some further discussions with some parties after the conference as I've mentioned. Our final report on the grocery market study will be available next year, on the 8th of March and that's a final deadline for us.

Once again if you've got any questions at all or you want to provide additional information to our team during the course of the sessions today and tomorrow, please just use our email address, which is marketstudies@comcom.govt.nz. And today the discussion will be chaired in part by Dr John Small and in part by Dr Derek Johnston. The Chair of the session, as before, will lead the discussion and the questioning and thank you for your assistance in facilitating that discussion through the Chair. That's enabled us to work well in the online format and to hear from everybody who's wanted to contribute, I think, as we've gone along.

For those joining for the first time, the conference is in a webinar format, so if you've indicated that you wanted to contribute to the sessions, then you will have been joined to the webinar as a panellist and that means that you can immediately and directly answer questions or make comments in the discussion. If you didn't indicate that you wanted to contribute to the discussion, you will have been joined as an attendee, but that doesn't prevent you from commenting if it strikes you that you'd like to in the course of the session. In that case, just use the hands-up in the Zoom function and our team will get in touch with you and join you into the panel so that you can contribute as you wish.

When speaking we ask that everyone, of course, turn their microphone on so that we can hear you and also your camera. If you're not speaking, please just keep your microphone off so that we can minimise feedback and background noise.

I reiterate again that if, for reasons of time or technology we're not able to hear from you in the sessions under discussion, and we haven't had much of that difficulty at all during these sessions, I don't think so far, we still would like you to just hold your thought and come back to us by way of written submission, or get in contact with our team and we'll arrange a follow-up session by way of meeting with you.

We can also save, of course, for private discussion any matters that you consider to be commercially sensitive or confidential that you want to come back with and that you don't want to raise in a public forum and please just let us know if that's the case. We fully expect that there may be some additional follow-up on some matters for discussion offline after the sessions today and tomorrow.

Finally, I'll just remind people that you'll see from your Zoom feed that the sessions are recorded, that's for the purpose of our transcription service and we'll be providing transcripts of each of the sessions in due course, I think the first two or three may be available this afternoon and then following.

Members of the media are also present but we've asked that the sessions are not recorded please by any third parties and members of the media may come and go throughout the sessions.

Thanks very much, I think that concludes the admin matters for today. I'm going to handover to John, I think, to start off the session this morning.

Dr Small: Thanks very much Anna and welcome everybody to this session. So just an outline of how we're going to proceed. As you know in the previous two sessions last Thursday we discussed improving conditions for entry, and in particular, how we might improve the availability of wholesale supply of groceries. In that session we didn't quite get to the end of what we wanted to talk about. We didn't get, in particular, to discussing operational and structural separation which may be required in connection with any regulatory regime for wholesale access to groceries.

So, we're going to start with that topic today and then additionally, move on to two further options for increasing competition that were discussed in the draft report. Those are divestment of existing supermarket assets and facilitation by Government of entry or expansion. Both of those latter topics apply not just to the wholesale level of the industry, but also to the retail level of the industry.

So, I'm going to lead this first part on operational structural separation which will be mainly about wholesale and then I'm going to hand over to my colleague, Dr Derek Johnston, to lead the discussion on divestment and facilitation of entry and expansion.

So, turning to this question of operational or structural separation, the key question to be addressed here is whether, if commercial arrangements are not viable and it's considered necessary or desirable, operational or structural separation may be required in order to provide and facilitate wholesale access and make that system work properly.

To discuss this, I think we need to start with a common understanding of terms. So I'm going to start with some definitions that hopefully will put us all on the same page in terms of aiding the discussion.

So, let's start by just being clear about the three different forms of separation.

The first one is operational separation. And what that means is that, in the case of wholesale, is that a wholesale only business unit would be defined within the vertically integrated firm. It would act like a distinct division inside the firm. For example, it would have its own leadership team, run its own budgets and accounts for itself, and report through to the broader firm in that way. That operationally separate business unit would be subject then to a set of rules and principles designed to achieve non-discriminatory access to groceries for third parties.

So, it's fair to say, we currently see operational separation like we've just described, as being a minimal requirement for effective wholesale supply by grocery retailers. And that view does seem consistent with what we've heard from the major grocery retailers who have indicated that they're not currently setup for wholesaling in the ways that we've discussed and I think we probably agree then, between us, that new dedicated units would be required if wholesale access is pursued, in which case, operational separation would be a basic design objective.

Structural separation goes a step further and shortly I'll ask you about whether that extra step needs to be taken or not. Structural separation goes a step further. It takes the operationally separated wholesale unit and turns it into a distinct company with its own Board of Directors. However, it still could be owned by the same shareholders as the retailer.

The third option is divestment. And whereas operational and structural separation are best thought of as wholesale market remedies, divestment could also be a retail market remedy, so it's relevant to the subsequent material that Dr Johnston will discuss. The key difference between structural separation and divestment is that under divestment that structurally separated business would be sold to different owners.

So, turning now to content and bringing people into the discussion. Suppose that we do get to a situation where we recommend wholesale access is achieved in some way, and as I said before this means in our view, currently it means operational separation as a minimum, then the question I'm interested to explore is, when should more significant interventions like structural separation be considered? In other words, under what conditions would it be appropriate to take that extra step?

So, I'd like to start with the small and entrant retailers first on this one and then hear from the major grocery retailers, so please put your hands up, Northelia, Night 'n Day, Supie or the Food & Grocery Council wish to comment on this question of when that extra step should be taken towards structural separation. Tex has got his hand up physically, okay, go Tex, you can start us, thank you.

Mr Edwards: Thank you Commissioner Small and thank you to the Commission. It's our view that there's ongoing conflicts from an operational separation and a structural separation may be required from day one, given the comment that the incumbents don't feel that they don't have a facility to do that as we speak. It's our considered opinion that because there's franchise structures in both incumbents, they could immediately work to an operational separation facility, pretty much from day one, pretty jolly quickly because they have franchise industry structure.

But secondly, I think everybody might feel more comfortable with the lack of conflicts that would exist if we went to structural separation because this structural separation removes information asymmetries and I'll close my opening comment by data is the new gold and this information asymmetry is quite substantial. Thank you.

Dr Small: Okay, thank you, thanks for that Tex. Matthew Lane from Night 'n Day.

Mr Lane: Good morning, Matthew Lane from Night 'n Day here. Look, I'm of the opinion that both operational and structural separation certainly does have its place but I don't think it should be treated as an either/or when it's considered divestment as well. The market is currently broken and it will continue to be until significant intervention occurs. What that looks like I'm sure we'll flesh out throughout the questions to come.

I think the key thing is, is to remove the conflict between wholesale and retail on the basis that even with structural separation, the same shareholders are still benefiting by the decisions made under that situation. So I think consideration needs to be given to how it can actually open up the market wider than just having the incumbents but separate entities.

Dr Small: Thanks Matthew, I take that as meaning definitely structural separation and possibly something more than that. So, Sarah Balle at Supie, you've got something to say on this.

Ms Balle: Yea that's right. There aren't many questions that have been asked on today's topics about when should interventions be considered and to what level or to what extent. And we need to remind ourselves why we are all here today. We need to be fighting for consumers and suppliers in a market that is so dominated by the power of two. It's created by retaining the status quo that has existed for far too long. NZ'ers deserve better, they deserve more.

Yesterday is when we should have been considering change. Today is about stepping up and making that change happen. So that tomorrow and in generations to come, we are delivering fair outcomes for consumers, suppliers and the environment.

So yes, we need change and we can't continue to protect a duopoly or ignore an industry that is so broken, particularly when we're discussing one of the five necessities of life which is food. So now there needs to be a full reset and we need support. And this comes from either structural or divestment of the wholesale market.

Dr Small: Okay, thanks for that, you're in the same position as Matthew there, okay, thank you. So, we should come to Foodstuffs and Woolworths for some comment on this particular question of the distinction between operational and structural separation and perhaps while you're at it, you might indicate whether you agree with our sort of current view that operational separation would be a minimum. Could I go to Chris Quin for something on this.

Mr Quin: Kia ora, Morena, good morning Commissioner Small, Chris Quin here from Foodstuffs North Island. So look, we would agree, this should be about what is in the interest of consumers and the benefit for consumers. Not suppliers and not retailers in particular. When we start thinking about this, the first thing we would say is, the drastic interventions that are being discussed here are only ever considered when there is a bottleneck or a central facility. And to date, measures like this have only been carried out with consent of parties. The purpose of the interventions is to allow non-discriminatory access to a monopoly facility so that competition markets upstream and/or downstream can be strengthened.

So as is clear from the last session, there is not a monopoly facility in the grocery supply chain, it is quite a different supply chain to some of the industries it's been compared to.

If we put that to one side, interventions to fix problems should be proportionate to the competition problem identified. And thus, where there are benefits for consumers that outweigh the cost, the risks and the potential harms.

Forced separation and/or sale of private enterprise are more intrusive than any previous interventions we know of. So, if they were to be justified, we'd expect to see a competition problem which is severe, which less intrusive remedies have failed to solve or could not solve. Such a problem doesn't exist here and just going quickly through our submissions in the conference to date, three points are clear from our point of view.

Consumers do purchase their groceries by way of shopping missions. We face competition from a range of different retailers for those missions across our full product range. It's not a duopoly with a fringe and we don't behave like it is every day. The returns of our business are normal and they're in line with the returns of overseas businesses and the story has been put on that not yet refuted. And NZ grocery prices are not high by international standards when compared properly at 21st of the OECD.

And I guess the last couple of points I'll make, description of franchises is incorrect. We're an integrated business where we have store owners who own their store and a number of the functions of operating that store and they are part-owners in a shared set of services that a not operationally separated in any way, which is why fundamentally we say we're nowhere near a wholesale organisation as per the definition the Commission's given this morning.

So that's probably opening comments on that, thank you John.

Dr Small: Thanks very much Chris, I mean, just to reiterate, I mean there's no decisions taken here and what we're interested in doing is exploring the contours of what might be appropriate. We certainly hear what you're saying about the hurdles for intervention. We would like to, you know, and you've made strong submissions on that, both here at the conference and also previously in writing. So, that is all, please be assured that we're taking that very seriously. What we would like to do, if we can today, is to nevertheless consider some of the details around where the standards are for different types of intervention. So that's what we're keen to do, we appreciate your comments on that. So, Andy Matthews, you've got your hand up, you've got something to say on this.

Mr Matthews: There's probably a few comments that could be made in response, but I think the main thing is to agree, it's normally only in relation to bottlenecks in particularly where there are a vertical and horizontal issues.

I think its incorrect to say it's only been done with consent. Katherine Rich, the Chief Executive of the FGC referred to Lina Khan's article and that goes through quite a number of instances in the US where there has been a separation over time, both from an anti-trust perspective but also more broadly, you've seen it in banking, Glass-Steagall and all of those sorts of things. You've seen it done by FCC regulations; you've seen it done by statute. We've had a number of industry restructurings in NZ, including electricity, dairy and of course, as Mr Quin knows, telecommunication.

So, I just don't think that's factually accurate at all.

Dr Small: Thank you, we are still trying to get at this question about when might it be appropriate to be structurally separated rather than operationally. Tim Donaldson from Foodstuffs South Island.

Mr Donaldson: Thank you Commissioner. With respect to the question, we've made substantial commitments in our submission on the draft report that will in combination deliver benefits for customers, improve outcomes for suppliers through the development of a grocery code and encourage competition by removing barriers to entry and expansion.

The market is changing with many new entrants, with disruptive business models, which look very different to us. For example, Costco, the world's third largest retailer is opening here next year and plans to open five to seven stores. And Circle K has announced plans to open 100 stores.

So change is happening and needs to be given time to bed in. We agree with the Commission's position in the draft report that drastic remedies only ever ought to be considered if other options prove ineffective.

Further, we haven't agreed that operational separation is required. All players indicated that it's feasible to provide access to wholesale products on commercial terms. A structural separation or operational separation should only be considered if more reasonable and workable solutions do not provide any outcomes.

I think it's also really important to understand if this remedy is introduced, does it then apply across all grocery retailers in New Zealand? That is, can it no longer be vertically integrated? This would have significant impact on the likes of Costco or Aldi and existing businesses like Supie. Thank you.

Dr Small: Thanks Tim. Just on the last point, the way I see it at least, and I'd be interested on your view on this, is that if you were supplying on a wholesale basis to other retailers, that would be an additional function for your business and an additional source of revenue, obviously, a wholesale revenue stream. But you would still be vertically integrated under either of the models that we're discussing here, operationally separated or structurally separated, you'd still have your own vertically integrated operation, it's just that you'd be bolting something else onto that.

So, I wonder whether, perhaps just to sharpen the question up a little bit and we might not get very far on this, but what sort of costs or lost efficiencies do you think we should take into account if we were getting to the point where we were starting to think about should the wholesaling operation be structural separated, bearing in mind that it would still be owned by the same company.

Have you turned your mind at all to even the broad categories of efficiencies that would be lost in that situation, perhaps we'll start with you Tim?

Mr Donaldson: Absolutely, thank you Commissioner. Look, operational or structural separation would add significant cost. You've got significant overhead and leadership teams. You would lose agility in the supply chain. One of the main benefits of our current business model is that we have integrated systems, it allows us to anticipate demand and changes in demand. And in simple terms, we're able to get the products where they need to go as efficiently as possible. That surety and agility of our supply chain was demonstrated during the Covid lockdowns where we responded to unprecedented demand spikes at no notice.

And it's our view that it would be difficult if not impossible to maintain that agility, that flexibility and that efficiency in operational or structural separation. It would, without doubt, add to the cost of operating and therefore the shelf prices of groceries.

Dr Small: Okay, thank you for that Tim. Josh Gluckman from Woolworths has got his hand up so it would be a good opportunity to hear from you, Josh.

Mr Gluckman: Thank you Commissioner and Morena, kia ora and tēnā koutou katoa, Josh Gluckman from Woolworths NZ. I suppose just to briefly cut to a view the points. Obviously we agree in relation to the hierarchy of intervention points that have been made. I think more broadly in terms of some of the mechanics of the specific questions that we're going to traverse during today's session or potentially tomorrow, we just note that a lot of them are pretty significant to say the least, and will take many months to work through the actual answers to.

So I think, you know, it's obviously not going to be possible to probably be able to provide a sufficiently detailed view in full and I think anyone who suggests that they've got a more definitive perspective is unlikely to have done that work at this point in time.

I suppose more broadly then just coming up a level around it, the comments around operational and structural separation and I think maybe just to correct the record, we don't agree the operational separation is a prerequisite or a minimum. We are open to exploring voluntary wholesale access if considered necessary over time, noting that there are various things that would need to be worked through as we traversed last week, which I won't do again today.

I think the statement made at the beginning probably presupposes that it's feasible to operationally separate and again we would note that there would be an enormous amount more work to determine whether that was or wasn't the case.

Certainly we'd imagine that if we were in the business of developing wholesale voluntarily, we might need some good systems to manage ordering, or manage separation in terms of cost to serve allocations, to manage different channel and customer terms. You might have some different oversight capability, whether that was buying or others, but that falls short of operational separation as outlined at the start.

So that would be our view. I can stop there or I could provide some views around structural separation Commissioner if you'd like.

Dr Small: That's helpful at that point, thank you Josh and I certainly hear what you're saying, there would be a lot of work involved in either of these, and we don't expect to solve all those problems today, but thank you for your initial thoughts.

There's a few more hands up and there's a gentleman, Mark Fort, we haven't heard from before so I'll come to you Mark and then back to you Chris Quin.

Mr Fort: Yes, good morning Commissioner. I think as far as the whether it's appropriate or not to separate, if it meets the obligation of the Government to ensure their citizens are not taken advantage of in their supply of groceries at significantly inflated prices, then it should proceed.

On the question of whether significant interventions be considered, when the companies who obtain supply and distribute the majority of a nation's food supply at unfair or unreasonable profits, then it has to be considered.

To sharpen it up a little bit further on whether it's technically feasible, I suggest that we've certainly heard from the companies involved here, the duopoly, that all their procurement systems, their supplier systems, they're all computerised, coded store, distributed from a few central DCs. So all companies, putting aside the grocery industry here for a minute, all companies go through restructuring processes to obtain benefits of development and new fields. And if we were listening to innovative discussion here, we would hear these companies say, "Wow, yeah, here's an opportunity, we'll separate our wholesale from our retail, let's get into it, this is interesting and we're going to do this country something wonderful". Thank you.

Dr Small: Thanks Mark. Chris Quin.

Mr Quin: Thank you Commissioner. So just to comment quickly on your question around what would cost of separation likely be or things that need to be done.

Look, I will very briefly say the problem comes back to the fact that the bottleneck is not clear. So defining what needs to be done is difficult in that light.

It was just mentioned the key drivers are a view on prices and profits. You know our view on that. And just to be clear from a Foodstuffs North Island point of view, we do not believe there is a case established for operational or structural separation, so just for recording our view on that.

We have, in previous conversations been clear that commercial wholesale, which could be innovative, could be a solution that could be developed, but without knowing anything about what service is to be separated in any way, it's very hard to comment on what cost would apply. We don't have a wholesale function as defined earlier this morning by the Commission. That would need creating and building. And the very systems that were referred to is where a lot of it sits in terms of creation of that.

Then there is the potential cost of potential asset screening of wholesale suppliers temporary or by design. So I thought there's a temporary leg-up or a natural advantage to be given that cost over what period would it need to be recovered.

And then the other thing that we worry about from a consumer point of view is that separation reduces the opportunity for efficiency. There is a reason why most of the retailers on this conference are integrated and that's because the opportunity to improve your cost from end to end is the key opportunity in a low margin industry. So we've been quite public our cost, roughly, to run our business is 15c in the dollar of grocery prices. This set of costs and risk would have to be recovered somehow and puts at risk any consumer benefits. We're working hard to try and go the other way and simplify the business and take costs out to keep delivering products. Thank you.

Dr Small: Thanks Chris, that's very helpful. What I propose to do here on this particular subject is just hear from the hands that are currently up and then we'll move to Dr Johnston's line of questioning. So that's going to be Sarah Balle, Matthew Lane, Tex Edwards and Josh Gluckman, we'll come to you last. So Sarah.

Ms Balle: Yeah, so I want to reiterate what Mark Fort said. If the majors find separation is too complex, too costly, too inefficient, too hard, then is there a case to be made, a government incentive to introduce a wholesale business which is innovative and world leading? And that will deliver the positive outcomes for new entrant such as Supie, in the expansion of existing retailers as one element to initiating meaningful competition. And we shouldn't be necessarily be considering the cost of this to big business, but the cost to consumers in the future.

Dr Small: Thanks Sarah. Matthew.

Mr Lane: I just wanted to touch back on a couple of points there and one is the continual reference of Costco or Circle K in terms of providing competition to the market. Now, Costco has one store that is on its way and Circle K has three stores that are currently in place. Now, I compare that to Foodstuffs' entire network of stores of circa 525 physical retailers. So I think when we're comparing those two by brands, there's massive unproportionable gap there in terms of competition.

And I would also like to point to Aldi, Costco and Circle K's involvement in this Commerce Commission review. From what I've seen, there's myself, there's Sarah and Tex, who from a retailer's point of view is really speaking out. I think that highlights the diverse nature of competition in NZ and lack of it where you point to the fact that Sarah from Supie (I mean no disrespect here to these parties) but Sarah from Supie's been in the industry for 3-years. Tex is looking at entering the industry and we've been incumbent in it for 30-years but our growth's supressed.

So I just wanted to make sure it's not clouded there in terms of the level of competition actually in the market.

I just want to touch back around whether operational separation is technically possible. Now this isn't a short-term problem. I don't think it requires a short-term solution. Now I certainly believe operational or structural separation can be a steppingstone to a more long-term solution, but it presents too many risks through operational separation for a competitor in the market, given the level of investment that would need to be committed. You want to protect your IP if you're going to invest at this level and provide meaningful competition. Operational separation should be considered to provide that short-term alternative, but should not be the final solution.

So I just, yeah, I do want to reiterate that I don't want to see purely operational separation cause it does not remove the market share of the incumbent, if anything it provides further profitability to them. So I guess, the unintended consequences we end up with suppliers still providing through to duopoly natured businesses and it really hampers the competition in New Zealand.

Dr Small: Thank you Matthew. So finally from Tex and then from Josh.

Mr Edwards: Thank you Commissioner Small. My observation here is for the Commission to consider when they're considering the balance between operational separation and structural separation. We urge the Commission to understand what the new bottleneck issues are. Here is a bottle, it's a bottle of tomato sauce. Here is the neck, here is the entry (points to the bottom of the bottle), the tomatoes go in here. We think that this is the bottleneck and I apologise to the Commission because in the balance of probability of the other issues that need to be discussed, the bottle needs to be discussed. This bottle is – the cap is recyclable, but the bottle isn't and I urge the Commission to consider, (I don't know what the appropriate ratio is) but is it 10% or 20% or 30% of the decision-making pendulum between operational separation and structural separation, climate change issues.

This week's Glasgow, I urge the Commission to consider the climate change difference between structural separation and operational separation. it's my opinion that structural separation would help climate change advancement in what a new supermarket looks like after the industry's reset, thank you.

Dr Small: Thank you Tex. Josh Gluckman, finally on this.

Mr Gluckman: Thank you Commissioner and just for the record I note that the first three Costco's will be the same size as 18 Countdowns and will have 40% of NZ's population within their 25-kilometre destination radius and will be supported by global purchasing scale of the second largest bricks and mortar retailer in the world.

But in relation to the question around the costs of separation. I suppose we'd strongly agree with the comments in the draft report in terms of extensive cost benefit analysis being required, which obviously hasn't been done to this point and the fact that structural separation would be considered an option of last resort. We envisage a number of buckets of costs that would likely exist and a lot of complexities and a high risk of unintended consequences.

In terms of some of those buckets. There would obviously be the direct undermining of efficiencies in terms of our vertical integration model in what is already a relatively small market, with risks therefore to the prices of groceries on the shelf. We would see a bucket of costs relating to undermine incentives to invest both in the NZ grocery sector and likely the broader economy because of the extreme precedent that such intervention into a sector such as ours would represent.

We would envisage significant direct costs in relation to the design of such a scheme, the implementation of such a scheme, the duplication that would result and the oversight of such a scheme and would also envisage a number of costs and risks to NZ relating to reduced supply chain resilience and agility where our vertically integrated model has been absolutely essential, together with our scale and how we've been able to manage feeding Kiwis during the Covid crisis. And we would note that NZ being the shaky isles, it is not unusual for us to face significant disruption within the supply chain. Thank you.

Dr Small: Thanks Josh, that was a good little list of categories there, that will be helpful for us. Greg, you put your hand up after I called time on this, but I will take a comment from you on this point then we'll hand over to Dr Johnson.

Mr Houston: Thank you Commissioner Small. Just a quick point in terms of the precedence for these kind of reforms and the practicalities with which that bears on this discussion.

So, if we take something like the Glass-Steagall Act which was mentioned by the FGC, measures like that apply to everyone in the sector and I think it's very important to bear that in mind, so if we were to say, well we need to have a separate wholesale and retail function, then it wouldn't make any sense economically and practically for that only to apply to a limited number of players. And I think it's very important to sort of bear that in mind if you have it subject to a minimum size threshold, say, which you could do and that would immediately establish a barrier to growth from people as they grew they would have to change their business model.

So I think in thinking about the costs and the implications, we also need to embrace the idea that some of the Circle K's, the Costco's, the Supie's, those who are on the radar or even in the process of entering and growing, should also presumptively have to think about what will be the implications of a reform of that kind.

Dr Small: Do you mean that Supie itself would have wholesaling obligations Greg?

Mr Houston: Well that would be, if you had, let's say you passed a law that said everyone is in retail, a grocery retailer, has to offer a wholesale service –

Dr Small: We did, I mean you probably remember when we talked about the Code of Conduct there was discussion about a threshold, is this materially different to that?

Mr Houston: Well if we did have a threshold, I guess that would be a size threshold, but then you're saying that everyone that's coming in as an entrant, when they get to that size, they have to alter their business model so to have an operationally separate wholesale and retail. And that would be immediately a barrier to growth.

Dr Small: Okay, I hear what you're saying, thanks for that. I'm going to call time in that discussion now, that was helpful and I'm going to handover now to Dr Derek Johnson to talk about divestment.

Dr Johnston: Thank you John. Good morning everyone. That brings us on to discussing divestment and Government facilitation of entry and expansion. And while our report treated divestment and Government facilitation of entry and expansion as separate topics and we'll discuss them as two separate topics today, I think we should bear in mind that they are not necessarily separate and they can actually be used in conjunction with one another and I think in submissions example was given of Telecom and the split of Telecom in the ultrafast broadband rollout with Government facilitation as to how some of these options might work together.

As has been noted, our draft report acknowledged that structural remedies would involve significant cost and risks and weren't a step to be taken lightly. Our report expressed our expectation they would only be considered if other options were not considered feasible, had proved ineffective, or did not appear likely to improve competition within the desired timeframe.

We note that both Woolworths and Foodstuffs have strongly submitted that you don’t consider divestment is appropriate, that the case isn’t made out for it. We’ve heard those views and I don’t think there’s a need to repeat those in this subsequent part of this session in addressing the questions we want to talk about around the divestment and facilitation of entry.

Really the purpose of today’s session is to have a discussion regarding the costs, risks and practicalities of these various divestment alternatives. What we’re keen to do is understand a little more deeply and have a better appreciation of what those risks, costs and practicalities really are so when we get to the end of thinking through all we’ve heard over the last 10-days and all of the other submissions we’ve received and will receive, and we’re ultimately minded to recommend divestment to improve competition in the sector, we do have a full understanding of what those costs and risks might be.

In relation to divestment, in our report we noted the risks that went beyond the grocery sector that potentially impacted on investment incentives generally. And similarly in relation to facilitating entry, we noted that the need for the Government intervention to have clear objectives, and to be undertaken in a manner that didn’t unfairly distort market outcomes in the long term.

So bearing in mind those generally high-level points, I’d like to look at the general principles that should be applied when one’s considering divestments in the context of a market study. It’s important to note that this is the first occasion in which the Commission has turned its mind to the possibility of recommending divestment in the context of a market study. So we want to take a step back from specifically focusing on the grocery sector and discuss more generally as a point of principle, when it might be appropriate for the Commission to recommend a divestment in the context of a market study and the framework within which the Commission should consider that.

So, I guess the first question I’ve got is in what circumstances might it be appropriate for the Commission to recommend a divestment remedy in the context of a market study? What preconditions or criteria should be satisfied before the Commission recommends a divestment remedy?

I think, perhaps coming to Josh Gluckman first, in your submission you made the point that divestment remedies would involve divestment being forced on someone. And so the key focus should be on what impacts a divestment would have on the operational efficiency of the party being forced to make the divestment.

Can you sort of elaborate on that a little in terms of what those efficiencies are, is it both lost scale efficiency and also lost efficiencies from the vertical integration aspect or are there other aspects as well?

Mr Gluckman: Certainly Commissioner, I’d be very happy to outline some of those specific considerations in relation to the grocery market but if it was considered helpful, I note that the first question also relates to principles more broadly and as you note this is the first time a market study has gone down this path. And notwithstanding the fact we haven't had too much time, I'd be very happy for Troy Pilkington from Russell McVeagh to provide some perspectives on the principles overall before I then provide some comment in relation to the specific grocery market application.

Would that be of interest?

Dr Johnston: I think that would be good and obviously we've got a lot to cover so if Troy can keep his comments succinct, that would be appreciated.

Mr Pilkington: Yeah Josh and thank you Commissioner. Morena, Troy Pilkington from Russell McVeagh.

So Commissioner Johnston, your question, specific question to Josh was around efficiencies but I think before we go and zero in on the narrow competition lens, I think it's really important to recognise that we're not just dealing with a competition issue, you know, which the Commission specialises in, but there's a whole lot of broader issues here around public policy, investment incentives for NZ, sovereign risk, property rights, common law, and consistency of international treaties, that would all need to be part of this decision set, so you can't really narrow your principles down before you've gone into that wider set. And so I think it's really important we start from first principles and build up from there.

And part of this, I've seen the Commission itself describe a market study is like a health check on an industry. So I think we do need to start with that same lens, well if you're doing a health check what's the first principles of obligations on a medical practitioner, the first one is 'first, do no harm' so that should always be the first principle when you're looking at any intervention. And you yourself said in your report, if you're looking at the interventions that you looked at and you rank them in order of social cost and severity, then divestments and these other structural options are by far and away the most significant end of the spectrum. And as you said, I think it's important you let the more usual, the ones that have been tried and tested, the ones where there's general consensus on to be given time to go through first and that would be consistent with those ethical obligations on a medical practitioner to try to lower interventions first and so those are where they've got the consensus.

But in terms of the general risks that you want to talk about in these principles that you want to apply, as I said, there's a whole lot of policy uncertainty if forced divestments was to become part of the remedy that the Commission might look at. There'd be reduced investments into capital into NZ and higher costs of capital.

So all those things need to be looked at and there's a whole lot of trade-offs there, policy trade-offs and decisions when a lot of those go beyond what you'd ordinarily look at within the competition lens. So I think that needs to be the starting point, is just recognising how broad the things are you need to look at before you then narrow-in on questions of competition and efficiencies as well. Thank you.

Dr Johnston: Thank you Troy, we'd certainly be interested in hearing about that in any cross-submissions beyond what's in the original submission you provided.

Coming to Foodstuffs North Island, Chris Quin, your submission has suggested that divestment would only be appropriate after a cost benefit analysis and as an option of last resort. Did you have anything you wanted to add to that?

Mr Quin: Thank you Commissioner. Look, I think without labouring a point that is being well made in this critical confiscation or even with recompense of privately-owned businesses and family stores across locations across NZ, would be unprecedented and would have established a problem for which forced divestment is an appropriate remedy which we have not.

I think some of the key parts, you know, given that our profitability is normal and that pricing is relative to the rest of the world, (and these points have been made already) we then start to look at potential impact or approaches to divestment where some of the ideas mentioned have been cherry-picking, central city stores, highest volume stores, those sort of things, they all have quite a significant roll-on infrastructure impact in terms of what it leaves behind as well as what it separates.

All of our stores are individually owned, which is different to the Woolworths NZ model and to other corporates who may be coming in the future. And the separation of and them and the divestment of them is quite a complicated and quite a different conversation. And given that the problems hasn't been established, it's been quite difficult to sort of work through and say, how should we go about that or what would the difficulties be? I think the difficulties starts with the lack of the problem being identified.

And given that competition exists in the form of any competition for a shopping mission, I think there is an assumption here that effective competition can only exist if it looks exactly like us and that isn't correct. Effective competition will not look like us, it will attempt to compete with a different proposition. And that is exactly what we are seeing emerging and some of the points are being well made on that. Thank you.

Dr Johnston: Thank you for that. I wonder if I might come to Tex Edwards and just to get a view from him as to whether he thinks those sort of criteria are the base ones before the Commission generally in any market study should look at divestment.

Mt Edwards: Thank you Commissioner. I'll comment and then I'd like to pass to my colleague, David Fougere, who's done some industry research on this and has some empirical data to share with the Commission.

Its Monopoly Watch's position that there's consumer harm, supplier harm, climate change harm, and the monopoly owned stores, which arguably are owned by families, but they're geographic monopolies, needs specific attention and a market study is to help the community and help the wider stakeholders. Not a small group of vested interested people. There's a precedent for divestment all over the world, this is not drastic action, it's not even a drastic suggestion, it's a rational, reasonable, tried and tested suggestion by the Commission which is still open for debate.

I'll pass to my colleague, David Fougere, thank you.

Mr Fougere: Thank you Commissioner. David Fougere from Phoenix Research, Morena. I just like to comment briefly.

I do feel that the public opinions on the question of divestment and unbundling should also perhaps be taken into account and so we were commissioned by Monopoly Watch NZ through Tex Edwards to run a survey, which I think is quite genuinely representative of the wider public views on these matters, and we got an overwhelming response of 70% of the NZ public believing that the supermarket chains did need to be unbundled. When we asked if people heard the Commerce Commission's report, that was around 50% of the population said they had heard of it. And amongst those people, 77% were of the opinion that unbundling was required.

So, I think almost regardless of some of the finer points, about what that unbundling should look like, I do feel it's really important that the wider public see a strong need for this. Thank you.

Dr Small: Thank you David, I'll come now to Tim Donaldson from Foodstuffs South Island.

Mr Donaldson: Thank you Commissioner. Given that a divestment recommendation is essentially a confiscation of private property, we think a number of preconditions or criteria would need to be satisfied before the Commission could recommend divestment as a remedy. Most importantly, the Commission would need to have a high degree of confidence that any adverse conclusions on the state of competition was soundly based and had been determined following a rigorous process.

We don't believe that the Commission has met either of these requirements. In addition, it will be necessary to have a high degree of assurance that the proposed divestment was appropriate for addressing any competition problem and proportionate to the magnitude of the problem identified.

It will also be necessary to carry out a careful assessment of the potential unattended consequences and a comprehensive cost benefit analysis.

The Commission might also recommend independent review of its findings by means of judicial standard process, such as a Royal Commission, or at the very minimum, another Government body. The factfinding analysis process engaged to date is not capable of supporting recommendations as radical as those that we've been discussing today.

And just on your comment around, or your question around, negative consequences, we believe they'll be substantial and including increased prices for the consumer. It could seriously impact NZ's international reputation as a place to do business. We think it could create uncertainty for NZ business owners if they think they're being perceived as becoming too successful. And every other vertically integrated business would understandably be concerned about this approach. Thank you.

Dr Johnston: Thank you Tim. Josh Gluckman you've got something further to add here.

Mr Gluckman: Yes thank you Commissioner. Look, I guess, obviously in our view, concepts such as forced divestment are extreme and unwarranted and would require consideration beyond a public sentiment survey, where I note that had those same respondents been asked, should the industry be separated to increase unit costs, then their responses might have been different.

But I suppose in the context here, there may be recipients who might benefit from expropriated assets but NZ's a modern, developed economy and any of interventions of this nature would require extremely high thresholds to even entertain. So obviously we're of the view that there's no such case that credibly exists in the NZ grocery market context. And a lot more cost benefit work would certainly need to be done before even entertaining.

In terms of some of the specifics on the costs, which I think was a topic of interest, you know, our business as we've noted, our efficiencies are highly sensitive to scale. So any impacts on our network would very quickly flow through to higher unit costs. Whether that was in relation to supply chain, IT, buying, management structures, online, analytic systems, you name it. Many, many, more and that would translate to higher prices, not lower prices for Kiwis at the shelf.

As we've outlined in our submission, actually, you know, illustrative economics on our business would suggest that for example, a 20% reduction in volume would flow through to a 5% increase in unit costs. And that includes adjusting for some downscaling of management. And, if you put that 5%-unit cost increase in context, remember our entire profit margin is only 2.4c in the dollar spent. So a 5%-unit cost is extremely material for even a relatively small, well not a relatively small, it would still be significant to our business volume reduction. So I think that that's an incredibly important point to note.

To then further suggest that forced divestment or entertained forced divestment be accompanied by some form of forced transitional arrangements, would in our view then be to only further layer in additional costs and complexities, including many of the challenges and the difficulties and the negative outcomes that are associated with forced wholesale separation that we've outlined already to date. And I think again, that's unlikely to flow through to lower prices for Kiwis, to agile or efficient supply chains or better outcomes at the shelf. And that's before one considers, I guess, all of the other broader ramifications that Troy Pilkington outlined in relation to NZ standing as a place to do business.

So, given those very significant impacts, we think it makes much, much more sense to work through a hierarchy of proposed changes and interventions that are less extreme that we do support and that we note that there's actually quite a lot of consensus around. Thank you.

Dr Johnston: Thank you Josh, we'll certainly be interested to hear in your cross-submissions a little more around what you think the appropriate thresholds are before we intervene. I'd like to come now to Katherine Rich.

Ms Rich: Thank you Commissioner. We hear words like extreme and radical, but what is really extreme and radical is the market concentration that has been allowed to grow in NZ.

To answer your question about the principles you should apply. Yes, you should be looking at the benefits outweighing the costs and looking carefully at benefits to consumer choice, price, innovation, food security and issues like climate change.

Another issue would be property rights, but I would suggest that there is no property right on a monopoly rent and I think that needs to be considered.

There's a policy inertia that I think has perforated in NZ, this idea that it's a small economy, we naturally distil down to duopolies. I don't think that is the case and I think that needs to be considered as a policy principle as well.

Finally, there's the belief, I suppose, that the Commission might have as to whether or not the duopoly can sincerely look at policy options and look at voluntary measures when we're in a conversation where the duopoly won't even admit that it's a duopoly. We've heard discussions right throughout this conference that there are no barriers to entry, that the market is fine and a duopoly doesn't exist. And if that's the case, and there is no acceptance that there is a problem on any level in NZ, then there is an issue for the Commission to decide as to whether or not divestment may be an option when you're dealing with players that don't sincerely and genuinely understand that there is a problem at all.

Thank you Commissioner.

Dr Johnston: Thank you for that Katherine. Tex, I'll come to you.

Mr Edwards: Thank you Commissioner. I can confirm I've been in touch with Standard & Poor's and Moody's, (that's Standard and Poor's in Downtown Manhattan and Moody's in London, Hong Kong office had closed by the time the agenda was here) discussing that point about negative consequences for NZ, exact quote was, "Its possible a credit upgrade is a consequence of vigorous and vibrant competition policy". So, it's neutral at worse. So worst case scenario for investment is no change in credit rating for NZ, but quite possibly an upgrade in credit rating as a consequence of vigorous and vibrant competition policy.

I can also confirm that I've spoken to three Woolworths shareholders and my favourite quote was, (this is an institutional shareholder of Woolworths based in LA) "They've milked an unsustainable situation, it's inevitable that they were going to get unbundled and a dominant player is always in the price". So in the valuation that investors are attaching to the stock price or the valuation of Woolworths, remember here we're talking to the owners, the owners of the institution of Woolworths who have literally hundreds of analysts looking at this, the biggest shareholder of course is an index fund, but below the index fund there's analysts who understand the market structure, that's why they're in the stock and it's just another day at the office to see something like a fair and equitable reset of the industry to benefit consumers and suppliers. Thank you.

Dr Johnston: Thank you for that Tex. Just while you're there, I'd like to sort of move on to another topic and that is, as we said in our report, we thought it would be only appropriate to look at structural alternatives if other options weren't feasible that proved ineffective or weren't likely to succeed. And that's been picked up by a number of other submitters. Consumer NZ suggested that structural remedy should stay on the table for 24 to 36-months. But if there wasn't a change in the market by that stage, then some structural intervention should be revisited.

I must say, looking at The Market (sic) Watch and Northelia submissions, I'm not sure you were quite in the same camp as that we should allow the work the Commission suggested around removing other barriers to entry to proceed, see what results they had before moving to structural remedies.

Do you want to comment on that Tex?

Mr Edwards: Thank you Commissioner. It's Monopoly Watch's position that it's taken us 20-years to get here. In the 20-years we've seen before this Commission of inquiry in the market study process has been canvassed now and the 517-page research report from the Commission completed, there's been some drastic irrational and outrageous behaviours from the incumbents and the issue is the 12, 24 or 36-months period that might go on after this Commission, it make very difficult to regroup. And it's illogical that there will be anything other than pyrrhic competition.

I refer to my industry colleague, Sarah Balle's comment earlier, of industry reset. We don't think there's the time or luxury to have another 3-years of the status quo and we think that the evidence is strong enough to actually bring forward what Consumer NZ would only do after 3-years of nothing happening.

So we think the timing is now and particularly the climate change urgency in which the first point of competition in the vision of the new world, supermarkets will initially be competing on climate change outcomes before they go into obviously pricing issues and supply issues. Thank you.

Dr Johnston: Thank you for that Tex, I see Chris Quin's got his hand up. Chris, what would you like to add on this aspect?

Mr Quin: Thank you Commissioner. Look, one quick comment and then two or three quick issues. So, look overall there's a number of statements being made that we disagree with. We don't think it's great use of the Commission's time to come back on every single one, so we'll deal with all of those in cross-submissions where we think the facts are incorrect.

Can I just make two or three very quick points though.

It is critical that the market is defined correctly for the future. There's a lot of conversation about the last 20 or 30-years. This market is changing fast, competitors are arriving in different shapes and sizes and whatever is considered to be appropriate to do, has to be about the next period, not the past.

With regard to consumer outcomes, which is what we all should be most passionate about, we have to keep remembering that for every retail dollar we have from a Foodstuffs NI point of view is 68c and that is made up of supplier cost of goods sold.

And we need to be as lean and as focused and efficient end to end in this industry as we can for the benefit of consumers.

And lastly a point was made that we don't accept there are opportunities to improve. That is incorrect, we have accepted there are opportunities to improve, we've made it very clear in our plan that we set out. And are underway with several of the actions including the removal of land caveats, with the work on pricing simplicity, engagement in code, and various other things that we have set out in our response to the Commission, so it is not correct to say we don't think there is anything that can be done, we've set out clearly what can be. Thank you.

Dr Johnston: Thank you for that. I'd like now to sort of change tack slightly and that is in relation to a divestment recommendation. The Commission has its own divestment guidelines that it uses in the context of where a divestment is required in a merger context and those divestment criteria look at a range of factors such as whether the divestment will address the competition concern, whether the composition of the divestment is appropriate, are all the assets there necessary to make the divestment effective, how do we prevent the assets deteriorating during the period of sale and divestment. And is there an appropriate purchaser out there who has expertise, experience and resources to run the business?

I think the Woolworths submission, perhaps downplayed the importance of the Commission framework when thinking about divestment and put quite big store on the impact of the loss of efficiency on the party required to divest. I guess I want to circle back to get a view from Woolworths as to what place it saw the Commission's divestment guidelines having in terms of the Commission's thinking about the need of divestment in the context of a market study and whether there are other things that we should be thinking about in terms of narrowing down on an appropriate framework thinking about divestment in the context of a market study.

Josh, do you want to pick that up?

Mr Gluckman: Thank you Commissioner, I'll actually pass to Troy Pilkington to pick that question up.

Mr Pilkington: Thanks Josh and thank you Commissioner. So from our perspective as we outlined in Woolworths submission, the Commission's M & A guidelines on its divestment framework in that context will probably only cover about 5% of the relevant considerations and it's probably at the very end, where you get to even applying those. So it's important to bear in mind that that divestment framework is for an entirely different scenario, it's voluntary divestment in the context of a voluntary merger in which the applicant has the ability to design the divested package, or ultimately choose not to proceed with the merger. And so at multiple points in those guidelines, the onus is on the applicant to determine what is sold. And that divestment framework is probably actually as we've said, the polar opposite of what you first need to consider in the context of a forced divestment.

So in the context of a merger, as you said Commissioner, the focus isn’t whether the divested assets will be of sufficient composition and have appropriate ownership and capital to replace the loss of competition from the merger. But in the context of a forced divestment, the focus would firstly need to be on what is the direct collateral damage to the ongoing viability and efficiencies and structures that economies of scale of the business that is being forced to divest part of itself. And then beyond that, before you even then get to the M & A guidelines, you then need to look at what are the other costs of society of that, we’ve talked about, impacts on investment and cost of capital, etc, arising from that.

And so all those things, before we even get to the guidelines go to a whole lot of other things which go beyond the narrow competition lens of M & A framework, and it’s also about all those competing and balancing policy inference that need to be considered and then once you’ve done that, it’s at the very backend, you might think we’ve gone through those things, done the cost benefit analysis, we’ve decided that a forced divestment is what needs to be done here, we’re tried all the other options and at that point you could say, apply some of the principles from those divestment framework and M & A guidelines around what’s the right purchaser, what’s the right composition, etc. But that’s, yeah, as I say, the last 5% of the conversation.

Dr Johnston: Thank you for that Troy. We’re about 5 minutes away from the morning tea break, or morning break. What I want to do is come to Matthew Lane and Mike Brooker, quickly, and then finish off with just finding out if anyone else has got any further views on the potential impact of a divestment remedy on New Zealand’s investment, attractiveness of New Zealand as an investment destination and round that discussion out before morning tea, that will allow us to move more specifically into retail divestment after morning tea. So Matthew.

Mr Lane: Thank you. I just want to touch on what criteria the Commission should use in framing its divestment remedy. Now, it’s our opinion it should be treated under the hypothetical, if Foodstuffs were to say, purchase New World as it was independently owned, what undertakings would have been affected to gain Commerce Commission approval? Likewise, if Woolworths were to acquire Fresh Choice and Supervalue in a competitive market, would that be allowed?

On a separate side, on the wholesale, if Wholesale Distributors Limited was independently owned and provided to the wider market in NZ and Woolworths NZ were to purchase that and remove independent wholesale out of the market, would it gain Commerce Commission approval?

If Foodstuffs or Woolworths NZ were to purchase any of the proposed divestment outcomes, would the Commerce Commission allow them to acquire these and create a duopoly based on what it knows now?

We also agree that the framework outlined in Attachment F is an appropriate framework to use. And I don’t think we want to lose sight of the fact that this is correcting a historical issue, as it happened over time to accumulation which hasn’t really led to a genuine transaction to cause it and there’s safeguards and understanding is in place and widely accepted for investment incentives within NZ. An example of this working is Ampol's proposed acquisition on Z Energy has been front footed with the voluntary offer to sell Gull NZ and to us that's other industries appreciating the need to keep competition in the marketplace while conducting their business.

Also to touch on efficiency. Look, it would be more efficient on the shore if Woolworths NZ and Foodstuffs combined. That would create a monopoly, that does great efficiencies if they're to be passed onto the consumer. I think we just need to look at the overall probability in absolute terms of these supermarkets and whether those efficiencies are genuinely being passed on to the consumer and whether or not we'd actually see profit reduction for supermarket operators and increased value to consumers.

Dr Johnston: Thank you for that Matthew. And now Mike Brooker.

Mr Brooker: Thank you Dr Johnston and I'll be brief and just answer specifically the question that's been asked which is around the merger guidelines. Mike Brooker, General Counsel for Foodstuffs NI.

In terms of those merger guidelines, I think that, I mean obviously there are pieces of work that's been robustly tested in the merger context but I would just question their transferability to this situation. In mergers there are obviously consensual transactions, they're voluntary divestments of potentially quite small parts of a business to gain access to the opportunity to merge. And it's done on a voluntary basis. Or it can be directed by the Commission of course. But if we look at, say, the Woolworths/Foodtown merger way back in the day, and we're in the supermarket context, there was divestment of two, or rather closure of one supermarket and divestment of one supermarket.

So I just think context is important here. But there are some points of principle that could be validity transferred and we talked about purchaser risk and you identified that and I think it is important to ensure that any purchaser has the expertise, the experience and the resources to be a valid competitor.

And in composition risk, that's a valid consideration and I think what's been borne out here in quite some detail is the complexity of this. So it's just not such a simple process as to just apply to merger guidelines as they are. I think all of this needs very careful consideration and we're talking quite drastic remedies in terms of property rights, so proper consideration is, I guess, all that we're saying. Thank you.

Dr Johnston: Thank you for that Mike. Now I'd like to come back to the question of the potential impact of the recommendations such like this on NZ's investment reputation as it were. We've heard some views from Tex and some input that he's provided. Are there other parties here who have comments they want to make on the potential impact of a recommendation from the Commission on NZ's investment reputation? Well if not, this is probably a good time to take morning break and we'll resume at 11.15, thank you.

Dr Johnston: Welcome back. The next topic we want to drill into is how a retail divestment may be effective. Our draft report suggested the divestment of retail stores may be necessary if it was thought improved access to sites for grocery retailing and wholesale groceries wouldn't be sufficient to encourage entry. We're interested to hear your views on whether there would be a purchaser for such a business, what assets it would need, and your thoughts on any divestment process.

Our draft report suggested a successful divestment of retail stores would be likely to require at least a network of retail stores that provided sufficient scale for efficient operation. Access to wholesale supply, the distribution system or access to logistic services on competitive terms and back office support.

I guess the first question I'd like to come to is, what is really required to establish a viable competitor to the major grocery retailers if we were to form a view that there was a necessity for another third serious competitor to the existing major grocery retailers, what would that competitor look like? What's the efficient scale required or the minimum number of stores which need to be divested to create a viable and effective competitor to the major retail grocers?

I'd like to start this section with comments from Tex Edwards. I think in your submission Tex, you suggested that in excess of 125 stores would be needed for a nationwide business and I think, in fact, last Thursday you had a number of 150 stores and in the wish list in your submission, I think you suggested a divestment of 200 stores for two parties. Can you please just take us through what you think is the minimum viable number for a serious viable competitor in the retail space?

Mr Edwards: Thank you Commissioner Johnston. The Monopoly Watch and the Northelia position is essentially that the market problem with the consumers and the suppliers is we need a like for like competitive reaction with like for like infrastructure with like for like customer ecosystem. So we have a pathway or almost a ladder of investment from a scalable start.

It's really noteworthy that I share with the Commission the evidence that it's Northelia's position that a minimum scale of 15% of the current $22b of market size, is required. That's because when we examined Australia carefully, we see Australia's 40/40/10/10 and we see the financial community who analysed the Australian supermarket structure, even though ACCC had a report in 2008, and we've had Aldi move to 10% market share, it hasn't had the vibrant impact on consumers. Remember NZ, we're a food exporting country, so we require a competitive reaction on both sides of the bottle neck. And I apologise for using my tomato sauce bottle, but it's really important that we do discuss the environmental impact of the bottle, not just the two components.

Minimum scale, 15%, that swinging pendulum of amount of stores is all stores aren't like for like. And we need the vertical integration problem resolved because from a standing start, you need like for like infrastructure back up at your DC. And again, we're talking about competitive reactions here, so we have a low margin business, although we have high margins and there's lots of excess profitability to pave for distribution, we have a low margin product and a capital intensive industry and after the capital intensity you've setup you can get high leverage which is another part of the component of this case, because the ability to get higher leverage equals the low capital component, but you need to sort of breach your J curve profitability.

So essentially it's 15% and that's based on some initial financial modelling and the difference in the number of stores really relates to what stores you have and what cities you're starting with. It's absolutely essential that there's a contestable and fair process and that we have qualified buyers for these assets.

And it's also noteworthy that it's our position that there's so much capital in NZ for supermarkets that we wouldn't need OIA approval and OIA shouldn't necessarily be required here, thank you.

Dr Johnston: Thank you Tex. I'd like to come first to Woolworths and then to Foodstuffs to get their reaction to what's required for a viable competitor in this space.

Mr Gluckman: Thank you Commissioner. Obviously our views around divestment are that it's pretty extreme or very extreme and unwarranted so I won't traverse that territory again. But I would note that in our view there are risks in even entertaining some of these conversations and some of it seems a little incongruous given the intervention hierarchy that's been outlined earlier, so I'm mindful of that, but I suppose, so my comments are in the spirit of constructive input into the conversation, but I'm wary of them being seen as anything other than that.

I suppose if I think about the question of minimum scale, the observation I would make is that we already and increasingly compete with retailers who don't even have physical stores or who only have a local presence or who only have a regional presence. And we also note that competition is likely to start small in scale as we've already seen and we've outlined some of the examples of that.

You know, and if we're thinking about price competition, you know, Costco, PAK'nSAVE, Aldi all demonstrate actually operating model, not just scale, can also determine things like price position. So, you know, even entertaining concepts like minimum scale, in my view and in our view, doesn't necessarily make entire sense. So, maybe I'll just leave it at that.

Dr Johnston: Just before we do leave it there, let's put aside the question of scale for a moment. What would you postulate is an optimal competitor in terms of an effective competitor, leaving aside necessarily being bricks and mortar?

Mr Gluckman: Well I'll probably come back to the some of the comments made on day one, Commissioner, which that we obviously experience competition in a number of different shapes and sizes and on a number of different dimensions. So I don't think there is such a thing as an optimal competitor. And I think in NZ, with whether it's the Warehouse, with their increasingly strong grocery proposition, both instore and online, whether it's the emergence of Costco which is very tangible and very real. Whether it's meal kits, whether it's Farro, you name it, whether it's the Chemist Warehouse, you know, there are many different shapes and sizes of competition. And they're all being provided with an increasing springboard to further grow because of this trend away from the main shop, which is a very pronounced trend.

So, I'm not sure I can provide more colour beyond that Commissioner.

Dr Johnston: Thank you for that. I wonder if Chris Quin, do you want to join in this part of the discussion?

Mr Quin: Thank you Commissioner, I'd love to. So firstly, I think, you know, we need to be clear and we have been clear. We consider that the market is not a duopoly, it has two large players and a fast-growing fringe. In fact the fastest growing part of the market is all what's been referred to as "the fringe'', that constrains our activity and it forces us to compete every day, which is good for consumers.

We have a direct competitor in Woolworths NZ and all of their capability and I think I'd start by saying the question presupposes that competitors need to look like us in order to be able to compete with us. Yet in the nature of competition that's not how it will occur today nor will occur in a digital future. Change is happening and happening fast and that's forcing innovation investment in our business along with everyone else.

We don't think there is a minimum efficient scale required to be a viable, effective competitor. Nine out of ten of our customers who come through the door are on a mission other than the main shop. Effective competitors for shopping missions come in all shapes and sizes. You effectively only need a single store to compete for a particular mission. I've mentioned it before, Fruit World Silverdale has cheaper fruit at different quality, different range and different service than PAK'nSAVE Silverdale, they compete and that is how it effectively unfolds pretty regularly.

Perhaps a final comment, there's been various versions of what is being asked to be forcibly divested and handed over to owners that are yet to be defined. You know, if you look at, if you say stores for divestment should only come out of Auckland, Wellington, Christchurch, Dunedin, Tauranga, Hamilton as was mentioned, that's effectively cherry picking the highest volume, lowest cost to serve stores, leaving behind a disproportionately set of stores and crippling the network from the point of view of giving regional communities the benefit of the centre communities.

So there are a number of problems as you consider this question of what would be nice to be handed to others, as opposed to what's been justified by the profit and price comparisons to date and then what leaves workable competition. Thank you.

Dr Johnston: Thanks for that Chris. I might come to Food & Grocery Council, Katherine Rich, in your submission, I think it's paragraph 7.3, you lay out a range of alternatives, ways that you thought competition could be created by various divestment alternatives. Do you want to talk to any of those?

Mr Rich: Thank you Commissioner. On this topic, I'll ask Andy Matthews to speak on our behalf.

Mr Matthews: My apologies, I confess I don't have the paragraph in front of me.

Dr Johnston: It's the paragraph that goes through various options like selling off the Four Square chain.

Mr Matthews: Oh yeah, thank you. Look, I mean I think they are put there recognising the issues that the supermarkets have raised, there are issues to work through. I think in terms of what you're seeking to address, it's just back a second to the divestment undertakings discussion. There are two points I think you'd be looking at trying to address, is what are the changes to incentives and the second is whether it facilitates competition. And I think FGC are agnostic I think in terms of trying to design the scope of who that competitor may be. I think it's sort of beyond its expertise, but just noted that there were those brands available.

And one point is picking up on what Chris Quin was mentioning earlier, to the extent there are owner/operator stores, there is the possibility that sort of not unlike in the fuels enquiry, there could be a loosening of restrictions around the ability to switch those different stores. I don't think we've got a view on what the scale of that entry would be like, I think that's beyond our expertise, they're just really options for consideration if you like and noting that there are brands there already and there's some ownership already.

There was one other point about or comments to the effect of ex-appropriation of assets and the like. I think we anticipated that if there were a divestment process then that would be to the divestment guidelines, probably a longer period than is required in the divestment guidelines, but also that there would be a competitive process so there will be a market price determination.

But I don't think that FGC were suggesting that it had a preferred option or a view on exactly what that should look like because I think back to the supermarket's point, it does depend a bit on the most likely forms of entry and whether they're going to be sufficient to scale to compete for the main shop for the portfolio.

Dr Johnston: Thank you for that Andy. I see Tim Donaldson's got his hand up, I'd certainly be interested in Foodstuffs SI perspective on this Tim.

Mr Donaldson: Thank you Commissioner. I guess the first point I'd like to make is that we are, we compete against and are constrained by many other retailers today. But any new national main shop competitor are likely to have a very different model to ours. For example, an online only model, in which case no stores are needed and Supie would be a good example. A fully private label offering like Aldi. A mixed model involving grocery and general merchandise options like Costco. So we would certainly caution against trying to create a competitor that looks just like us.

As has been covered before, we're totally opposed to the concept of confiscation of our members' businesses, which would be unprecedented. Nonetheless, if the Commission persisted down this path, there would be a significant cost to bringing together a set of divested stores under one distribution and sale system and one brand identity. And as has already been mentioned in a low margin business, this would only lead to an increase in cost for the consumer. Thank you.

Dr Johnston: Thank you Tim, I see Matthew Lane's got his hand up, Matthew.

Mr Lane: Yeah, just from Night 'n Day's point of view on this. We see a very simplistic option is split by brand that the problem isn't necessarily the amount of competition by brand in NZ, its competition of obtaining supply and obtaining competitive supply. So it would be in our view if you could split off a full independent brand, it gives quite a transparent process, but also what it does is it could anchor an independent wholesale supply.

I'm not suggesting owner/operators have to divest their business, instead change their buying behaviour to purchase from an additional wholesaler instead of the current duopoly vertically integrated supply, which then gives the chance for other independents to compete.

And just on the, I guess, ability to bring stores within networks, as Andy Matthews touched on, I did make an approach to Foodstuffs around whether or not they would consider removing their restraint of trade to promote competition in the market given the fact that a number of their stores are owner/operated and have made approaches to or some have made approaches to us in the past to convert, but felt it was unfeasible due to the restraint of trade imposed on them, which allows no divestment of market, even if their owner/operator wants to switch.

Dr Johnston: Thank you for that Matthew. Just while we're talking about choice of stores, I wondered, Tex, in your submission as I read it, had a couple of different alternatives as to how you'd go about store selection if it was thought necessary to make some selection of stores. We've certainly already heard Chris Quin's comment about the impact of, potentially cherry picking the most profitable stores. Can you sort of elaborate on how you would think about store selection?

Mr Edwards: Thank you Commissioner Johnston, yes. It was the Northelia position that store selection should really address the economist's problem that we have, which is geographic monopolisation. And in the course of the conference last week and the week before, we've heard about there being pockets of monopoly where, in any 5-kilometre/8-kilometre/12-kilometre radius, we have maybe six Countdown stores and one Foodstuff store. Or, in some areas, we might have five or six Foodstuffs store and one Countdown store.

So essentially, it was Monopoly Watch's position and Northelia's position that an HHI ratio (Herfindahl-Hirschman Index), a monopolisation ratio, market share squared, around 5 or 8-kilometre radiuses would be calculated to work out what pockets of stores were not competing. It was really important to the Monopoly Watch team that in the opening day of the conference, there was no competition in top-up shops. And the challenge here for Northelia is to create like for like competition across a network in both top-up shops and main shop shops.

So it was the HHI ratio in 5 to 8-kilometre radiuses, so just pinpoint these suburban monopolies or suburban dominance where there were contiguous stores that could be unbundled, point one.

It's really important to stress that it's a contestable process that Northelia was advocating. It might not be Northelia that participates in any potential divestment if the

Commission chose that that was appropriate. And it's important that we catalogue that a fair valuation on a Tobin's Q basis might be one of the appropriate methods to sort the divestment.

And I might also just attend to my industry colleague's concern about cherry picking stores. As is the case in other third operator behaviour, we would visualise some type of regulatory commitment to expand to national coverage. It's really important to Northelia that the Government has spent $560m building a rural broadband and we feel that we'd have like for like coverage in our product offering with a hybrid physical stores and internet offering, something like what my industry colleague, Sarah, was offering.

So, essentially, you have to start somewhere, you have to start with like for like competition, you have to start with scale and any challenger would be qualified via meeting some criteria as is mentioned in Attachment F. And we see like for like coverage sorting out that national problem, thank you.

Dr Johnston: Tex, while you're there, you're talking about a contestable process for sale of the divested stores if there were to be divested stores and that there should be a fair price for those stores paid. Do you want to elaborate on that in terms of how you would envisage a contestable process running and what would be a fair price? I think you talked in your submission about an acquirer shouldn't have to pay monopoly prices for the stores. Do you think the contestable process would be adequate to set the price for the stores?

Mr Edwards: I think we'd need some guidance from the regulator who's trying to achieve some economic benefit for consumers, suppliers and the environment. And essentially, the contestable process would be NZ based, NZ owned capital pursuing some type of bid or some type of qualification process so they were qualified (in financial markets everybody calls it qualified institutional buyers) but in this situation it might be qualified food distribution operators. And they would register with some process and then the Commission would select assets.

It's not property misappropriation because if we check the fine print in the Woolworths accounts, we notice that in the debt financing structure for Woolworths, they actually have a specific paragraph about how their business might be changed if regulatory environments change. And most Woolworth investors have constructed knowledge of this lovely market structure. So I don't think it's anything that's crunching property rights, it's already been disclosed.

So essentially, contestable process would be something that the Commission might seek the opinions of somebody better qualified than Northelia or Monopoly Watch. You might be talking to game theory economists. You might be talking to a portfolio of a group of investment bankers who would come up with some process to do a sort of Attachment F divestment. Thank you.

Dr Small: Tex, can I just follow that up, I mean would you agree that there's a bit of a tension here between, on the one hand, having a contestable process for sale which would reward the existing owners appropriately in a market context and on the other hand, I think in your words, not baking in monopoly rents or access returns. Is there a fundamental tension there that you see and if not, why not?

Mr Edwards: Absolutely, I think that this is the risk that we have here is that if there was a forced divestment, NZ is such an attractive international investment destination and you'd have a queue of people wanting to participate in a triopoly. And this is quite a complex economist's problem to create like for like competition, have ongoing competition incentives and consumer benefits and that's why we highlighted circa 15%, circa 125 to 175 stores as the basis because that would force a challenger to have to continue to expand their footprint. Not dissimilar from national roaming, where you've got a toe in the market at scale and then you're renting other people's infrastructure until you got like for like competition and like for like scale.

And I absolutely understand and have concern about your problem Commissioner Small, that if you had the wrong type of process, essentially, the incumbents, Woolworths and Foodstuffs sell their stores at monopoly prices to a challenger who has such a high component of goodwill in them, you can't see this natural fertilisation of pricing, climate change and supplier issues. The moment you're buying assets at Tobin's Q valuations at things that are closer to the non-monopoly rent prices, you've got quite a different situation.

And if I could just give you one working example at the practical earth level, today we've got the Woolworths team or Countdown team sitting in their office in Ponsonby. On one side of Ponsonby ridgeline there's Bunnings and the other side of Ponsonby ridgeline is their other Grey Lynn store in Richmond Road. Now, Bunnings, the store sold for $20m and rent is under $1m. The other store in Richmond Road sold for $45m and its rent is circa $2m. And so that just shares with you this economist's challenge in resetting the industry, how these very big issues need to be resolved to puncture the monopoly rent for the challenger purchaser. Thank you.

Dr Small: Thank you.

Dr Johnston: Tex, I think if I understood you correctly, you're suggesting that the pool of potential purchasers should be limited to NZ capital. I really wonder whether that doesn't actually unduly restrict the range of potential purchasers that should be available, aren't there a range of international purchasers who could bring expertise and depth of capital and potentially create another effective competitor? Why shouldn't they be allowed in the mix in terms of considerations as potential purchasers?

Mr Edwards: Thank you for that Commissioner Johnston. One of the issues there is that Foodstuffs have prided itself on being a NZ owned business and we respect that. And Woolworths Australia always prides itself on doing the right thing. It's no secret that Northelia is in discussions with a couple of iwi groups and we've been authorised to mention that we're discussing with iwi groups – not that that should give any privilege in purchase, but the issue here is that property acquisition is always sensitive and it makes sense that it's a NZ owned business working with NZ suppliers.

And in terms of expertise, in many countries in the world, you would expect to have a 10/20/30% technical partner. So you might have somebody else's brand. And I actually refer to the ownership of Vodafone today. Vodafone is essentially owned by Infratil NZ, but it has a technical services agreement with Vodafone PLC. And we see that as a fantastic model. We are talking about the NZ economy. This is a NZ Commerce Commission in NZ albeit digital today, and we just feel that we should take the opportunity in an industry reset to use some of that surplus capital, surplus capital that wants to invest in supermarkets, thank you.

Dr Johnston: Thank you Tex. I'd like to come to Chris Quin, I think in your submission earlier Chris, you were saying that you saw contestable process was appropriate. Do you think that the contestable process is going to achieve a fair price in terms of the sale of these assets?

Mr Quin: Thank you Commissioner. I think you will forgive us for saying again, the case would have to be established for cause for this and benefit to consumer and it has not at this point.

Dr Johnston: I understand that Chris.

Mr Quin: If any process was to be pursued, it would absolutely have to be contestable to establish market value of these businesses. And we would keep referring back to that generally they have been voluntary in nature, because the ownership of our businesses, our stores, essentially, is basically a structure of an owner/operator who owns the business, employs all of the staff, owns the fixtures and fittings of the business. The land and building is owned by a cooperative in which they are a shareholder, but with protections around what can be removed by shareholders from that cooperative. And a very complex situation to look at to say, how do you sell a store and such.

There's been some other comments made about our owner/operators and whether they can leave. We're probably best to deal with this in the confidential sessions, but you know, owner/operators can leave and do, but the co-op continues to generally own the property, hold the lease or own the brand, and that is what it would, you know, it has a duty to retain.

So, I think the answer is, no other process being contestable would make sense but there's a long way to go before it seems like the market situation justifies the action, thank you.

Dr Johnston: Thank you Chris. Josh, do you have a view on these questions of process if one was to go down the divestment route and setting a price?

Mr Gluckman: Thanks Commissioner, a probably brief view insofar as we obviously don't think divestment is required or warranted and therefore we don't think it would be appropriate to have strong views in relation to process. In fact, in our view to even in engage in discussions around process and criteria, it's not only premature, but actually carries some risks, for example, in relation to investor uncertainty. Thank you.

Dr Johnston: Thank you. I think just on the question of risk, I think that was the next question I wanted to come to. In terms of the potential challenges that would need to be overcome with a retail divestment. Potential risks or unintended consequences associated with the retail divestment, I think we've heard from both Woolworths and Foodstuffs, a number of the risks that they see and the unintended consequences. But I think at this point I'm sort of keen to hear if there are any other risks or unintended consequences that haven't yet been raised that we should be aware of. Nick, you've got your hand up.

Mr Hogendijk: Thank you and good morning. I think the question that sticks in my mind is, what's the risk if you don't do something? I'm hearing a lot of unintended consequences, I'm hearing a lot of scaremongering around, oh it's very complicated. It's the same noise we've been hearing now for five sessions prior to today. There's all these complexities that keep being thrown in, but what if you don't do anything.

You know, Costco, at the size that it is, is not a threat. It is by its own estimates, roughly speaking about NZD$138m per store for food, sundry and food product sales. That means that it's not even the size of a PAK'nSAVE, so it's not 18 stores for a Countdown network, at the best they'll have three stores, that's not competition. You know, Supie is an online retailer and is still very much in its infancy and is not a meaningful competitor to these retailers at the moment and yet your consumer prices are high.

Suppliers and retailers alike are actually going to have to face into the fact that market competition needs to occur. It will drive prices down. The Aldi impact in Australia has been between 13% and 30% price reduction across the board since it entered the market in 2001 and you need that sort of competition to come back into the market to rebase your consumer pricing so that the NZ community benefits.

So the risk isn't about if you make all these changes, it's not about a patient getting a health check. It's about a responsibility to the NZ public and society and economy to put a competent competitive marketplace into a workable solution that is not driven by scaremongering from people who don't want to have change come about, thank you.

Dr Johnston: Thank you for that Nick, we've got four people with hands up so I think I'll go next to Greg Houston, then to James Mellsop, then to Mark Fort, and then Allan Botica and then after that we'll move on to the next topic.

Mr Houston: Thanks Commissioner Johnston. I think that the most important potential unintended consequence here is that a retail divestment of a group of retail operations that were a significant size, the response to that would simply be that they would seek to establish their own integrated supply arrangements just in the same business model that all of the other businesses we observe in NZ and mostly around the world do. And I think the observation from that has to be that integration is the most efficient business model for grocery retailing. Now, I'm sure there are exceptions around the world, but the norm is integration.

So, you have to contemplate the possibility that your divested retail would ignore and seek to bypass the wholesaler that you left behind and re-establish an integrated supply chain just as the two incumbents and just as the three emerging entrants that we see trying to do in NZ.

Dr Johnston: Thank you for that, James.

Mr Mellsop: Thanks Commissioner Johnston. Actually you raised just before the break the risk to the, sort of cost of capital and I actually was keen to say something but didn't quite push the hand up, but I think if I can make a comment on that now, if that's okay?

Dr Johnston: By all means James.

Mr Mellsop: Thank you. Andy Matthews sort of made the argument earlier that there are precedents for this so I don't think that's actually correct. Certainly not in groceries globally and certainly not in NZ in any market. And the Telecom split is not really a good analogy because that was basically done voluntarily so that Chorus could compete for the fibre.

So what that means is that there is a risk to investment certainty if a divestment is recommended. And it's not just to the grocery market, but it's to many markets across NZ.

Now, coming to the cost of capital, that may not come through in the CAPM WACC. Rather, this is more likely to be regarded as a sort of idiosyncratic or asymmetric risk that would come through in hurdle rates for investment. And for example, the value of waiting for new information or more certainty would mean the real option would be more valuable and therefore it would be rational for investors to wait. So investment would be delayed as a consequence. And you know, this is not just a theoretical framework. The Electricity Authority adopted exactly this framework recently when carrying out its cost benefit analysis of transmission pricing methodology changes. Just to put that in a sort of real example of a NZ agency taking this sort of risk into account in the CBA.

That's all I wanted to add, thank you.

Dr Johnston: Thank you for that James. Mark.

Mr Fort: Yes, coming as a previous supplier to both of the chains, over a 30-year period, I note that whatever the negative consequences that might be, they have to be weighed against the current negatives of the overpriced supply in the current grocery bill for much of the population. The duopoly, through no fault of their own, but good people employed, have bedded in a wonderful system over the past 25-years to maximise their profits, to the expense of our population. I'm just reinforcing things that Nick's said and others have said and spoken, thank you.

Dr Johnston: Thank you for that Mark, and Allan?

Mr Botica: We keep hearing of difficulties in costs. It suggests that the principle risk in the Commission's terminology is that of asset risk, the erosion of value through weakening tactics by the current owners. And I'd suggest that a counter to that it's a matter of will. Now let me give you an example.

Josh and Tim, earlier, both mentioned the sectors exemplary performance during the Covid response. That's instructive because they didn't engage at that point in protracted discussion and equivocation about costs, risks, difficulty, they simply got on with it and they benefited. And the point about that is that the question that this comes down to is one of Government intervention.

The Government has already intervened significantly in this sector giving extraordinary protection and privileges to this asset class. And in Auckland, you can still see that because the protection is ongoing and it will be enduring. Instore access is available through supermarkets, everyone else had to make do with click and collect. That's a protection that no other sector gets, thank you.

Dr Johnston: Do any of the other Commissioners have any questions on the question of retail divestment before we move onto wholesale divestment?

Dr Small: No, that's fine thank you.

Ms Rawlings: I just have one question Derek, just for Tex, that occurred to me as you were speaking, talking about domestic versus overseas investment and you mentioned that you had discussions with iwi in your discussions about how things might look or feel. And I just wondered whether those discussions for you are a matter of access to capital more generally or whether you think there are uniquely Maori perspective or benefits that could be derived from some degree of iwi ownership or involvement as well?

Mr Edwards: Thank you for that Commissioner Rawlings. I actually have a text which him authorised to read out from an iwi group, and I'll just see if I can find it on my complicated phone. "As discussed, I will send you a formal note from our consortium of iwi. However, for the purposes of the Commerce Commission discussion, you can state that Northelia are looking to work with a group of iwi throughout the country to ensure that any sell down remains in NZ hands, in particular supermarkets that fit well with our values and are focused on health outcomes for Maori". I'd be happy to detail that in more detail in submissions, at the moment I'm authorised to say nothing else other than that.

But, we specifically discussed health outcomes with the iwi leader I was in negotiation with. And it sits well with their values and they did discuss the Sealord's success of Maori ownership and partnership with the technical partner.

Ms Rawlings: Thanks for that. I think that would be a useful thing to follow-up if that's alright at a later time.

Mr Edwards: I'd be delighted to.

Dr Johnston: I'd like to move on now to the question of wholesale divestment and I guess where I want to start with that is just risk around that. We've, I think, heard quite a lot around risk in connection with the wholesale divestment, this or the need to separate the business.

Secondly, Greg Houston was saying, at the end of the day we'll probably just end up with another integrated entity anyway, this seems to be happening with Metcash in Australia. And I think it's a question as to whether there's enough potential custom to actually make a standalone wholesaler viable without a separation of sufficient stores so that you've got a customer base or an integrated operation.

I was wondering, has anyone got any contrary thoughts on those questions, or any particular comments they want to make around a wholesale divestment or risks around divestment of wholesale assets?

Tim Donaldson, I see you've got your hand up and then Chris Quin.

Mr Donaldson: Thank you Commissioner. I think the key thing here to discuss is that actually for wholesale supply, no assets need to be divested. It's possible in NZ to contract all supply chain and transport services, the need for anyone to setup as a wholesaler if they wish. In fact, this would be the best option for a large new wholesale player and is possible using standard business practices. Thank you.

Dr Johnston: How does that address some of the concerns we've heard from some of the smaller players about they don't feel they've got much option in terms of getting groceries at contestable prices for retail purposes?

Mr Donaldson: I think that's a really good point to explore Commissioner and something that we briefly covered on Thursday with respect to wholesale pricing in what you pay. As you know we're a fully integrated retail business. A central team that provides services to enable retail stores across PQRS. And half of our SKUs go direct to store.

But I'd like to clarify one misconception which wasn't clear on Thursday.

Other retailers seem to think that Foodstuffs achieves cheaper prices purely due to volume purchased. That's not correct. The retail price stores pay for products is made up of two broad variables.

The first is the purchasing term and that's the price we pay for products. This price often reflects the high volumes we purchase and reflects that it results in lower costs for suppliers.

But the second is suppliers' trade spend. And this is the spend that suppliers choose to spend with us to market and promote their products. This spend is determined by the supplier based on their own objectives. Our understanding is that for suppliers, it's an important part of how they control the manner in which their products are marketed to consumers through various channels. And this spend has a material effect on the resulting cost price. We anticipate that a wholesaler would be able to negotiate purchasing terms on volume, however trade spend component would remain a negotiation between the retailer and the supplier.

And so for absolute clarity, this trade spend component would not be in the purchase price from a wholesaler. Thank you.

Dr Johnston: Thank you Tim. Chris Quin.

Mr Quin: Thank you Commissioner and I'll try not repeat some of the points Tim has just made. But I think the key points that I would add or reinforce would be, we need to be clear what wholesale business means in this context. We have through the conference identified that there is really three components. There is the logistics and access to that and we've shared material on the fact that that is easily available to many from third parties.

There is the volume part of buying and then there is the trade marketing spend part of buying.

And I just add, it is quite difficult to imagine how you would operationally separate the relationship between a supplier's marketing investment and the retailer's execution with a wholesale layer so it creates another complexity in any potential design.

The other risks that potentially exist from is, where does every step away the margin or profitability get recovered that each organisation would require and what does that do to price, to consumers as opposed to integrated models where everyone's trying to make the process as lean as possible from supplier all the way to the shelf.

The agility of supply chain so all of the issues around forecasting, demand planning, allocation of resource and stock. All of those sort of items become more complex with these sort of layers and more risky. Which all leads to really the point that's been made which is why people end up heading back towards an integrated model. And even some of the suggestions from potential new investors are saying they would only want assistance for a period of time. I think that indicates and talks to the fact that integrated retail models are the digital future that we're all thinking about. And in fact the challenge in front of us all is how to take layers and cost out of that industry rather than add it in. Thank you.

Dr Johnston: Thank you Chris, some interesting thoughts there I'd like to come back to in a minute, but I'll take comments from Tex and Matthew and then I think that might get close to wrapping up our wholesale session, Tex.

Mr Edwards: Thank you Commissioner Johnston. I just urge the Commission to discuss and consider when they're making these decisions about the value of data and how it impacts whether it's structural separation or operational separation or complete divestment. Data is the new gold, we know that, that's where the cost out is coming. But I think there's an indicative little working example here of what some of the problems are.

Its noteworthy that Foodstuffs, both North and South Island are way behind Countdown in adoption of internet sales. And some of this comes as a consequence of the restraint of trade that the individual Foodstuffs stores operate under. The Henderson can't go out to Westgate and start competing with each other. That's a really important piece of DNA here. And when I discuss it with the Commission of the possibility of a divestment of the distribution centre, it's noteworthy that individual store ownership might not have to change. It might be that the decision that is appropriate to reset this market is essentially that Foodstuffs operators start competing with each other.

Back in the day, Onehunga used to compete with Otahuhu. Today, the infrastructure in Foodstuffs is so well choreographed, Onehunga is not allowed to compete with Otahuhu, and that's why somebody who lives on the border of Otahuhu and Onehunga, isn't getting a good internet service, they haven't got a good proposition for Foodstuffs.

So just consider that because it could really take a lot of the anxiety from individual Foodstuffs store owners that needn't suffer from if they just changed their distribution centre. Thank you.

Dr Johnston: Matthew.

Mr Lane: Thank you. Look, if I was to say what is our biggest problem as a retailer trying to grow or compete in particularly the dry grocery market, it would be access to non-conflicted wholesale. I've repeated that time and time again because it's been the biggest barrier to us growing in that particular space.

I just want to touch on an example where we did rely, well we do currently rely on Woolworths for B to B supply and have done for a number of years. Now, we ended up in the position where we were left high and dry through this cause as Covid struck, there was a surge of demand and it just sort of highlighted the fragility of the overall wholesale supply. We were left with the maximum of $800 orders for our stores to try and supply our vulnerable customers which, if you use average basket size of the shops at the supermarket, that would equate to 16 customers per week. And to further contextualise the wholesale supply that we required compared to the total market, it works out to be 0.001 of a percent they could not service to us. That's what was limited to. That's the problems we face if we invest in this area and build customer bases associated with it.

I do call for independent wholesale ownership and I don't think it's out of the question that the Government could help facilitate this. To assist not one entrant, two entrant, three entrant, but give the ability to have six, seven, eight, nine over time. I don't think we want to limit ourselves to only have access on a large scale, to large integrated supply and for that reason I think it needs anchored by an existing banner. Also with independent wholesale supply, it gives the opportunity for retailers to work directly with the source supply, whether that's Edmonds, Chelsea, or the like to work out promotional planograms, to work out how to grow market share, to have that transparency associated with it. That's how it works in other wholesale suppliers and I'll point to Bidfood, I'll point to Amalgamated Food. You have the ability to work with the supplier, we don't have any supply issues through those suppliers and everyone is treated as an equal right away across their customer base.

Dr Johnston: Thank you for that Matthew. Chris Quin your hand is still up, have you got something else you'd like to add at this point? I'll go to you Chris if you've got an additional point you want to make, and then to Josh.

Mr Quin: Thank you Commissioner. I just want to make sure that we clarify some statements made about lack of competition between Foodstuff stores.

That is completely incorrect, they compete avidly between each other. The PAK'nSAVEs quoted, just one really important fact, PAK'nSAVEs don't do delivery from online, that's part of the lowest price promise. They do click and collect, they actively market to a wider customer base as will travel to their store for that service.

All of our stores consider that every customer is theirs to compete for and there is no restriction on them competing with each other.

We're happy to cover that further in cross-submissions and confidential conversation if the Commission wants. The only possible link that could be made would be that we do planned delivery areas but we have a series of A and B. The B areas overlap with other stores, so proving we do actually compete between the stores. Thank you.

Dr Johnston: Thank you Chris. Josh.

Mr Gluckman: Just a very brief comment Commissioner just to note that Night 'n Day example provided really just in our view highlights the challenges of dealing with third parties in emergencies, such as Covid, which is a point made in our submission.

Dr Johnston: Thank you, note that. I think we've heard both from Chris Quin and also from Greg Houston that everything in the grocery world is tending towards an integrated model or tends to have proficiency to head to an integrated system. I note however Matthew's comments to the contrary, that it's important for some parties to have access to a separate wholesaler. Focusing now on the desirability of an integrated grocer. If there was to be an integrated grocer as the new competitor, as it were, I'd just like to explore whether that's achievable by reason of divestment of assets from the two existing retailers and the consequences or potential risks around the model such as that.

So, the question is, would there be a purchaser available who would be interested in an acquisition of the assets necessary to set up an integrated grocery model? I guess I'd just like to start with Tex on that score, the model that I understand from your submission is you're saying divest a group of retail stores and then we'll do everything else that's necessary apart from a wholesale store as it were, to get supply, to get all the backup services.

Do you see any advantage in divestment of sufficient assets for an integrated operation as distinct from a divestment of retail assets?

Mr Edwards: Thank you Commissioner Johnston. The original proposal was essentially to get a retail footprint where scale was achieved and then use that scale to build a third distribution centre which is sort of really needed to help the competition dynamic. And so it was always achieving enough scale on day one to enable investment incentives to build third, possibly a fourth distribution centre footprint through NZ which would fundamentally change on a game theory basis how these stores integrated. I will come back on that point about Foodstuffs inter-shop competition issues, I'll do that in submissions.

But essentially, an integrated operator was needed because we've got these pressure points in the distribution chain. My initial submission was that there'd be a wholesaling environment, there would be a style of operational separation up at the distribution centre and then a footprint of stores that got scale that could migrate to its own distribution centre.

I actually agree with the comments from colleagues in Woolworths and Foodstuffs that we do need competition at the distribution centre and the moment that a game theory economist and some substantial analysis is done on the difference between having a duopoly of DCs, to three operators, possibly four at the distribution level, it actually helps resolve some of the tremendous anxiety in the room that prices are going to go up. I mean, we refute that allegation outright, but the moment we talk about a sensible pathway to actually a bricks and mortar, steel, concrete, plastic, hopefully a lot of wood, in a new DC, which would obviously be integrated with other players in the market, and I'm thinking here of an internet only proposition, some of the smaller bespoke, smaller suburban stores. Because if we look at how competition, where are today of where we need to go to, there's always a consortium or coalition of challenges who often come together on things.

And so I just sort of highlight that in terms of there's quite a bit of grey an ambiguity from the pathway of two DCs to three DCs to four DCs and the moment you've got a third and fourth DC pathway, you're actually going to resolve some of those big anxieties that distribution costs may go up as a consequence of scale. Because what normally happens innovation comes in and costs will go down across the whole network, thank you.

Dr Johnston: But on that Tex, as I understand it, you get the retail stores, you have 3-years to develop a distribution warehouse, or stores, but you still need the supply contracts with suppliers to get the goods to go into the distribution centre and into the supermarkets. You're seeing that that's something the new entrant would do itself?

Mr Edwards: Yes, I mean that's a ladder of investment process and we would envisage, or our proposal whenever we did our initial financial modelling on it, was that there would be this step-stone path, a little bit like the ladder of investment done in other industries where you're stepping up your ladder of investment from on day one, you've got pure wholesale with a whole lot of covenants around the quality of wholesale and the quality of data and then you're migrating to a third distribution centre and you're stepping up with your own supply agreements which really is achieving the clear and present objective to establish more competition. It's Northelia's point and it's Monopoly Watch's point that competition is not at the fringe. Competition in this environment, because of the status of the duopoly, because of the rapacious profitability, but pass that to one side for the moment, the lack of innovation, and the bad treatment of suppliers, that we need the third distribution centre pathway and the KPIs that the third DC or the fourth DC are going to trade on are quite different from what we've got today. Obviously I spoke about environmental supplier equity and consumers. So, does that answer your question Commissioner?

Dr Johnston: I think so, yep I think that's quite helpful. I've been focusing on either a divestment of retail asset, retail stores, or divestment of the wholesale business if it was separated off. Just trying to explore whether a divestment of assets sufficient to create an integrated operator at day one, so it wouldn't make perhaps more sense and how that might look and how that might work. But I suspect there'd be sort of a range of difficulties, many of which you've already heard around divestment such as that. But again, be interested in either Josh or Chris Quin's view on divestment of sufficient assets across the two networks to create an integrated competitive operator from day one, Josh?

Mr Gluckman: Thank you Commissioner. I'll try and provide a perspective. I mean vertical integration is obviously a model that we see providing a number of benefits and I think many people have pointed out the reason that it's prevalent around the world and it's also a model we're seeing be deployed from more and more of the competitors and new entrants into the market here in NZ, you know, The Warehouse, etc.

I think to try and create a vertically integrated competitor through a divestment of assets, which I think is the question, it's something that would be incredibly complex and would require a huge amount of work to even get our head around.

I suppose the analogy for me would be, and so far as we are a vertically integrated operator, for us to divest assets to create a separate vertically integrated operator is a bit like asking a person to divest their skeleton. So a difficult concept to work through.

So, I think just given the nature of the short notice and the significance of a question like that I'm not sure I can provide much more comment.

Dr Johnston: That's fine, I understand, we're looking for a sort of high-level reaction, so are there others who want to comment on comparison of a vertically integrated divestment as distinct from divestment of retail assets, Chris, I see you've got your hand up.

Mr Quin: Thank you Commissioner. So, just trying again to be brief and to the point on this. I think it is quite difficult to see how a divestment of the integrated slice that is being described could be achieved. You know, the business doesn't operate in the chunks that are being described. They would need to be built and created, there would have to be quite some complex problems solved to do that.

And as we've talked about we don't have a separate wholesale function as defined at the very beginning of today's workshops. That would need to be created and the delineation that is being described would potentially be created across many operations or many services that are not previously delineated or we haven't seen other models that do that.

I guess, the one other point I'd make is there has been quite a lot of conversation that agrees integrated, digital and moving forward seems to be the key for efficiency consumers competition for the future. There is basically nothing that we're aware of today, once our action plan is implemented, that is in the way of anyone entering this market investing and competing.

So, we would also question not only the issues around the lack of proof or around the profitability or price problem, but the fact that there's simply isn't the barrier to someone setting up an integrated competing offer and having a go at winning customers. Thank you.

Dr Johnston: Thank you for that Chris.

Dr Small: Just setting aside where we've actually just been in the last few minutes about the divestment issues, a theme that's come through a little bit here and I think perhaps it was Greg Houston that highlighted it perhaps most, but it is clear anyway that vertical integration does have some efficiencies. We've heard from Northelia that that would be their plan would be to end up vertically integrated. I took it from Greg's comment that he thought that this was, in a sense, a negative feature of any proposal to try and see if a third network could be established.

So if you don't mind, I'd just like to circle back on how the parties would envisage, suppose that there were another one or even two vertically integrated chains, of scale, so that we had a total of three or four, rather than two, how would that change the dynamics of wholesale from the perspective of someone like Matthew Lane, and other retailers, who need access to wholesale groceries, which was kind of where we came in right from the start of our competition analysis.

Do you think that that would be sufficient or do you think, in other words, do you think there'd be wholesale competition and I wondered whether Woolworths and Foodstuffs would see themselves, for example, courting that business in preference to it going to the third or fourth player. Any views on how that might work?

Mr Gluckman: We obviously do have an open mind to wholesale supply on commercial terms if required or considered necessary over time. And certainly we would consider that that would be more like to result in flexible, efficient and fit for purpose solutions, than many of the more extreme options that have been entertained over the course of, well not just today, but certainly today.

So I think that's really our context and we don't consider that the steps towards doing that are insurmountable, suffice to say that they are complex and need some working through because we're not currently setup with that type of model.

If we were to do that, it may well be the case that that would actually become quite a competitive context for supply into many various different types of customer groups. Whether that was a Night 'n Day or a group of independent dairies or a general merchandise retailer who wanted to extend, or many other players. And we certainly think a voluntary commercial model is much more likely to be able to meet the needs of a wider range of potential customers, which would itself be a feature, I think of a likely grocery market outcome.

Dr Small: And do you think that would be more likely to occur if there were three or four networks than it is at the moment, cause to be honest, you don't seem particularly keen, currently, to go down that route. I guess that was my question, do you think you'd be perhaps keener to do that if you had another large-scale rival?

Mr Gluckman: I'd prefer to give that particular question some more consideration Commissioner, but I think that the reason we haven't done it to date is simply because we're a vertically integrated retailer and our focus is on end to end efficiencies and agility and innovation in supply. So that's our frame of reference, so that's the reason we haven't done it to date.

Dr Small: Thank you very much. Chris Quin.

Mr Quin: Thank you Commissioner. I think again, not to repeat, but to try and extend a little. I think firstly it is still unclear what the wholesale customer requirement is, split between logistics, product supply and volume and then marketing support from suppliers. So, to some extent to answer the question, you need to be very clear on what the customer need would be. And you know, both the major retailers have B to B wholesale arms that are dealing with businesses who have come to buy off them and attempting to offer service, but we're also seeing that when you go into the level of service that is required to get a different price to a retail price on shelf.

So it's unclear what it is that's required. The issue of the supplier marketing spend has been established several times. And I guess the question would need to go a little bit to those new integrated retailers as to whether they think there would be value in being a wholesaler to the rest of the market. And I don't know the answer to that question, I think we would need to understand more about what that market was seen as and what the opportunity is which is why you come back to saying, the recommended way is that we have a voluntary wholesale environment where the commercial realities will determine what works.

Dr Small: Thanks for that.

Dr Johnston: We had hoped to move on today to facilitation of entry and expansion but we're down to about just under 10 minutes. So I propose to hold that over, we've got time tomorrow to deal with that in our day that we retain to allow us to pick up topics that we didn't cover adequately.

I think we've actually had a very good discussion today. As I said at the outset, what we're wanting to do today was to really probe beneath the service and test what the costs risks and potentially practicalities of these various alternatives we discussed are. I think it's been very useful to get feedback on all of those aspects, I've certainly found it very helpful and I thank you all for your contributions on that.

Just before we close, I just like to invite a few parties for any final observations they might have. I thought I might start with Northelia and then ask Josh at Woolworths and then Foodstuffs NI, Foodstuffs SI for any brief comments. Tex, did you have any comments?

Mr Edwards: Thank you Commissioner Johnston. It's the Northelia position that like for like competition, like for like infrastructure in a new age digital environment is what's required here to solve really substantial competition problems. The competition problems are all encompassing consumers, suppliers, and the environment. And I articulate this because didn't think I gave this point justice earlier so apologise to the Commission and the participants.

[Holding up a bottle of squeezable tomato sauce] This is the bottleneck [points to neck of bottle]. This is where the supply of stuff comes in [points to the bottom of the bottle]. Traditionally, Northelia and Monopoly Watch have made a mistake because we thought it was the bottleneck infrastructure, how quickly can stuff come out of the bottleneck which is the supermarket. We actually have to discuss the bottle and I think that 20% or 30% of all decision making needs to be around the environmental impact of any challenger. We're in a new age now, currently there's a massive climate change conference in Glasgow and it's my closing point on this second to last day Commissioner, that it's the environment that needs to be considered in addition to these other items, thank you.

Dr Johnston: Come now to Josh from Woolworths.

Mr Gluckman: Thank you Commissioner. I think there were some gnarly and interesting questions discussed today and I think, very complex, and would all require a lot more work and I think anyone who suggests that they've got the definitive answers to them probably hasn't done all of that work at this point.

Certainly from our vantage point and perspective, many of the structural options or all of the structural options that we've discussed today come with significant risks. Significant costs and significant complexity and the likelihood of significant unintended consequences. And those include direct costs, in terms of the impacts on our efficiencies and our end to end operating models and the outcomes for consumers as a result. But also wider costs in relation to impacts on investor confidence, innovation and NZ standing as a place to do business as has been outlined by others.

So in that context we think it makes a lot more sense and continues to make a lot more sense to start first with a number of the less extreme options that have been outlined and proposed in the draft report. And that we do support and that we note there appears to be quite a bit of consensus in relation to, whether that's grocery code, site availability, etc. And we noted also tried and tested in other jurisdictions abroad, so I think that would be probably our closing comments on today, thank you.

Dr Johnston: Thank you for that Josh. Chris Quin.

Mr Quin: Thank you Commissioner, a few points. There's been many comparisons made to the telco market through the conversation. I think it's just really important to return to the fact that there was a clear monopoly asset in that market structure and there is not in this market structure. So the thinking has to start from the beginning of that principle.

I think secondly and we've said it multiple times, so please I'll keep it short, there has not been proof that there is the remedies are needed to improve competition. The conversation around profitability and around price comparison to other markets, we've been very clear about our position on it and that's still being discussed and resolved.

So, as we anticipate the Commission develops its view of the nature of competition in this market, you know, we all want to see where that lands in terms of what, if any, remedies are required.

The full separation, forced divestment of assets would be unprecedented even if there was a monopoly, which there isn't in this case. And we've made our point around the fact that the structure of the business today where many NZ families who own our businesses all over the North and South Islands would send quite a damaging signal from that point of view.

The last thing is, a lot of good talk about let's focus on consumers and the benefits for them and still through the conversation today, it hasn't been identified that the remedies would increase efficiency, in fact we believe they would reduce it. That has an impact on cost and eventually price to consumers. It's not clear how it would improve competition and I think some good points have been made around the different future of competition, that it will be more digital, less physical, that it will be more innovative, that they will be leaner and more simpler and more efficient models. And it's really, really important as we consider how to keep improving this market everyone's putting so much energy and passion into, that we don't use regulatory tools from the 20 or 30-years of the past to control the future, thank you.

Dr Johnston: Thank you Chris. Tim Donaldson did you have anything to add from Foodstuffs SI perspective?

Mr Donaldson: Thank you Commissioner. Yes, we'd just like to point out that the remedies being discussed today are not supported by evidence. Many of the remedies outlined in the Commission's draft report were premised on the Commission's analysis of profitability. We've demonstrated to the Commission that our level of the profitability is in line with international comparisons and is therefore normal and appropriate. If the Commission objectively considers our expert's analysis of profitability, then it follows that most other remedies discussed today are likely to actually increase the cost for consumers by adding additional cost to the supply chain.

Furthermore, today's discussion is not the appropriate forum to design the framework for divestment of any nature. And we would endorse the Commission's view that forced confiscation of private property rights is a remedy of last resort and would require further significant analysis. Thank you.

Dr Johnston: Thank you for that Tim. As I said earlier, I think this has been a very useful and constructive session in terms of helping our understanding around a range of issues and I'd like to thank everybody who's contributed this morning to make the session productive and thought provoking. If the people online who've wanted to contribute to today's discussion but haven't had an opportunity to do so, please get in touch with us by email at our email address, marketstudies@comcom.govt.nz and we do ask that all further submissions or comments be with us no later than 23rd of November which is the date for closing of our cross-submissions.

As I said we didn't manage to complete the discussion of facilitation of entry and expansion which we hoped to cover today, so we'll pick that up tomorrow, along with the question of whether there's any other strategic behaviour which might restrict new entry and access and how that might be addressed.

So we'll pick those topics up at 9.30 tomorrow morning and there'll also be an opportunity for some parties to make some closing address before we bring the conference to a close. So once again, many thanks to everybody for the contribution today and look forward to seeing you tomorrow. Thank you.