The Warehouse Group Submission on Foodstuffs merger

Non-confidential version

9 February 2024

1. The Warehouse Group (**TWG**) is grateful for the opportunity to submit on the proposed merger between Foodstuffs North Island (**FSNI**) and Foodstuffs South Island (**FSSI**). In TWG's view, the combination will not be in the best interests of kiwi consumers. It will accentuate the serious competition issues already identified in the Commerce Commission's Market Study into the Retail Grocery Sector, Final Report dated 8 March 2022 (**CCMS**) and make it harder to achieve genuine price competition that results in lower everyday grocery prices to consumers.

2. The FSNI/FSSI application for clearance (**Application**) describes numerous markets in which one or both parties compete, and Commission's Statement of Preliminary Issues (**SOPI**) sets out a number of theories of harm being tested. However, the key concerns can be identified in three core claims made by the merging parties:

<u>*Claim 1 – There is no competition between FSSI and FSNI today, so none to be lost*</u>

> ***"There is no existing competition between the two co-operatives at the retail level (whether the supply of groceries to customers, or the acquisition of groceries from suppliers) or wholesale level" (Application, para 3) …***
>
> ***"Together the Parties present a single national bricks-and-mortar and online retail grocery offering through common brands" (Application, para 24).***

3. [ ]
[ ]

4. [ ]
[ ]
[ ]
[ ]
[ ]
[ ]
[ ]

5. [ ]
[ ]
[ ] In a market where competition levels are already poor, any loss of competition must be material.

---

[1] [ ]
[ ]
[ ]

Claim 2 – The rationale is to generate cost efficiencies which will be passed on.

> ***"The purpose and practical effect of the Proposed Transaction would be to merge the management and operation functions of the support centres, which as above already have a close relationship." (Application, para 5) …***
>
> ***"By combining the best aspects of both co-operatives, a single, fully integrated national support centre structure (with supporting supply chain infrastructure) would reduce the complexity, duplication and cost of running two co-operatives. As a result, the Proposed Transaction will:***
>
> > ***20.1 lead to cost reductions (including overhead costs and product costs), efficiency gains, increased agility, and innovation,***
> >
> > ***20.2 result in a Merged Entity that is leaner and more resilient, more efficient, and faster at adapting to customers' changing needs, and***
> >
> > ***20.3 ultimately deliver better value for customers at the checkout and thus enhance competition" (Application, para 20)***

6. Very similar statements were made in 2013 about the merger of the Auckland and Wellington Foodstuffs entities. And yet in 2020 a market study into grocery was initiated because of the poor grocery market outcomes for consumers and suppliers. There is a real question whether the promised benefits from the Auckland/Wellington Foodstuffs merger ever, or even mostly, eventuated. The Application does not mention them.

7. The same statements, by the same organisation, a decade later should be treated with caution. Ultimately, if the Commission remains in doubt as to whether the combination will lead to increased buyer power leading to higher profitability of the combined entity, and whether there will be any pass-through of efficiency gains to consumers, then it cannot be satisfied that no substantial lessening of competition will arise from the merger.

Claim 3 - The Commission can rely on the Grocery legislation to fix any issues and make sure savings are passed through to consumers.

> ***"In particular, the pro-competitive changes introduced under the Grocery Industry Competition Act 2023 (GICA) (particularly the wholesale supply regime), increasing retail competition more generally and the Commerce Commission's (Commission) ongoing role in monitoring and promoting competition in the sector, should be expected to ensure significant competitive (and regulatory) pressure to pass through the benefit of savings and efficiencies to customers." (Application, para 7)***

8. This submission assumes costless regulation. It also assumes that the Commission has the power to deliver outcomes through regulation that are better than competition; orthodox regulatory economics assumes the opposite.

9. If there is a real chance that, as the bargaining power of the combined entity is enhanced, the public cost of more expansive regulatory intervention will be higher in the factual, then the Commission cannot be satisfied that the merger would not substantially lessen competition. This is particularly the case with the GICA, which is currently at its inception, and is structured to involve triggering of future investigations, and the layering of more expansive and intrusive interventions over time, many of which may not be required if competition were to operate effectively. Competition will work more effectively if regulated retailers, including FSNI and FSSI, are required to compete harder, including for wholesale supply.

10. It is unclear how the Commission can be satisfied, to the point that it is left in no doubt, as to whether the counterfactual would involve greater competition between FSSI/FSNI, including their franchisees and interconnected or associated companies. [ ]
[ ]
[ ]
[ ]

11. TWG sets out below in more detail its view of the relevant issues arising from the Application and SOPI.

[ ] **(Claim 1)**

12. There is a strong emphasis in the Application on the assertion that there is limited (and, in the counterfactual, will not be any) competition between FSSI and FSNI or any interconnected or associated company, including any franchisee. This includes an assertion that there is no competition:

- within the FSSI group: between FSSI (Trents, as a business division of FSSI) and Raeward Fresh Richmond/Tasman and Harewood (FSSI franchisees), despite overlapping wholesale offerings (Application, para 38-39);

- between FSNI and FSSI in relation to their strategic approach to market due to co-ownership of Foodstuffs (NZ) Limited (Foodstuffs NZ), "a non-trading entity which represents the two co-operatives' interests on issues of national or grocery-specific importance" (para 40) that appears to control the retail strategy of both co-operatives (para 42.1) and appears to engage in setting common marketing (para 42.3), which presumably extends to common pricing;

- between FSNI and FSSI (or any of their franchisees or interconnected or associated parties) for national buying of own brand products (para 43);

- between FSNI and FSSI for wholesale supply:

  (a) between Trents and Gilmours (despite participating in national tenders, which presumably requires a consistent service offering across New Zealand), due to their operating in different geographies (para 141) and given the wholesale service offering being differentiated (para 36); or

  (b) between either co-operative and any other group/franchisee-owned wholesaler (para 142); or

- between FSNI and FSSI (or any of their franchisees or interconnected or associated parties) in the future - because there will be no change in "volumes" or "quantities" purchased (paras 116, 118, 132).

13. The assertion is that consequently, on the retail supply side, the

> *"Merged Entity's overall bargaining power will not be greater because the Parties do not compete with each other to procure a greater share of supply … The Proposed Transaction would therefore result in no change to share of supply, or quantity supplied, in any geography" (Application, para 132.3)*

14. Similarly, in respect of procurement for wholesale supply, the assertion is again that:

> *[The] "Proposed Transaction is not capable of having any effect on the acquisition of groceries from suppliers for wholesale supply. As with retail supply,* ***the Proposed Transaction will have no effect on the volume of groceries the Parties acquire*** *for wholesale supply, either overall or in any geography." (Application, para 136)*
>
> *(Emphasis added)*

15. TWG recommends the Commission carefully tests the suggestion that there is no merger specific change in volumes of wholesale purchases modelled by the parties in the factual. For example, the Commission could test whether the merger is intended to facilitate growth (which would presumably lead to increased volumes).

16. If no growth is modelled, and yet the merger is predicted to generate procurement synergies, then there is a real risk those synergies will include cost synergies arising from a reduction in the price of groceries acquired for wholesale supply derived from greater bargaining power of the merged entity. TWG notes this is a matter the Commission can and should inquire into, including by asking for, and examining, the modelling of synergies undertaken to support the merger approval process through the respective franchisee groups.

Even if there is no competition between FSNI and FSSI, there may still be a substantial lessening of competition caused by the merger.

17. The suggestion that the parties do not compete today, even if accurate, is not enough. It is not an answer to the question of whether there is a real chance of the merger giving rise to a substantial lessening of competition because this can arise from conglomerate or coordinated effects,[2] as the Commission identifies in its SOPI. The OECD describes conglomerate effects in its 2020 Paper on Conglomerate Effects of Mergers:[3]

> *"Conglomerate effects arise when the products of the merging firms are not in the same product market, nor are they inputs or outputs of one another.* ***Such mergers could enable tying and bundling strategies that foreclose competition, enable price discrimination, or soften competition among firms****".*
>
> *"several new contributions have uncovered situations in which conglomerate mergers could generate harm – almost always when the post-merger firm will have the* ***incentive and ability to foreclose competitors with tying or bundling strategies****. The harm from these strategies arises only in particular circumstances, most importantly* ***a lack of effective competition in at least one market****."*
>
> *(Emphasis added)*

18. The Application does not address either conglomerate or coordinated effects, and only observes that:

> *"there is also a small number of cases where the two co-operatives currently procure the same product but from separate suppliers as a result of choice ... As part of ongoing ranging decisions* ***there may be***

[2] Conglomerate effects concerns are outlined in the Commission's Mergers and Acquisition Guidelines (at 5.11 to 5.15), along with co-ordinated effects (3.84-3.90).

[3] https://one.oecd.org/document/DAF/COMP(2020)2/en/pdf.

***some opportunities for two individual island-wide suppliers to be replaced by a single national supply contract**." (Application, para 132.4)*

(Emphasis added)

19. It is inevitable that the bargaining power of suppliers, when faced with a request for a single national supply contract post-merger, would be materially reduced when compared to suppliers facing a similar request today from two separate entities with separate supply arrangements. The reason for this is because of the conglomerate effects arising from the merger.

20. TWG recommends the Commission considers whether the impact of the greater symmetry of scale and cost structures between the merged entity and Woolworths New Zealand could increase the risk of co-ordinated effects, particularly in procurement of groceries for wholesale and retail supply.

There is currently a lack of effective competition.

21. The CCMS Chapter 4 findings in relation to the major grocery retailers, Woolworths, FSSI and FSNI included:

- *"Competition in the retail grocery sector is not working well for consumers.*
- *NZ grocery prices appear high by international standards.*
- *Profitability of the major grocery retailers appears high.*
- *The scale and pace of innovation in the sector appears lower than expected.*
- *Competition in the wholesale purchasing of groceries is not working well for many suppliers."*

(CCMS Summary of Findings)

"Other grocery retailers do not provide a material constraint." (CCMS p99, see also CCMS, 4.161).

22. The Commission concluded in its Summary of Findings in Chapter 6, Conditions of entry and expansion:

"it appears unlikely under current market conditions that any new grocery retailers (or existing grocery retailers seeking to expand) will be able to achieve the scale and geographic coverage required to compete effectively with the major grocery retailers." (CCMS, p189)

23. In TWG's view, the merger is likely to simply make the issues identified in the CCMS worse, creating greater barriers to retail entry and expansion at scale.

There is an incentive and ability to foreclose competitors with tying or bundling strategies (and other strategic conduct), including under the GICA.

24. In the CCMS the Commission found that any a large-scale retail competitor would need to establish its own wholesale purchasing directly from suppliers (making it vulnerable to strategic conduct by the major grocery retailers), and that a scale independent wholesaler is unlikely to emerge:

"Our assessment is that any large potential competitors to the major grocery retailers would largely seek to establish their own wholesale supply (at least in the long term), rather than make use of the wholesale supply of a separate wholesaler. This, and international evidence, suggests that it is unlikely that there would be sufficient demand to support the successful entry of an independent wholesaler without an associated retail operation." (CCMS, para 9.124.1)

25. The Commission will recall that its Recommendation 5 in the CCMS was accordingly to "monitor strategic conduct that affects the conditions of entry or expansion." The Commission noted:

"In Chapter 6, we discussed a range of conduct by suppliers and retailers which could potentially affect the ability of new entrants or existing firms to source products at competitive prices. This includes:

9.130.1 suppliers refusing to supply grocery retailers which set retail prices below a certain level (either on their own accord or due to pressure from other retailers);

9.130.2 supply arrangements affecting the terms on which suppliers can supply to other parties, including exclusivity of supply agreements and best price clauses; and

9.130.3 attempts at strategic acquisitions of actual or potential competitors.

9.131 We have distinguished this conduct from other terms and conduct between retailers and suppliers (discussed below and in Chapter 8), as they primarily relate to the conditions of entry and expansion, rather than issues of bargaining power.

9.132 All of this conduct is potentially subject to the Commerce Act 1986, and ***independent of this study, the Commission will be alert to strategic conduct that may breach the Act in the future.*** *We note that the Commerce Amendment Bill currently before Parliament contains amendments that will strengthen the Commerce Act's prohibition against the misuse of market power, and could potentially be used in relation to some forms of strategic conduct by major grocery retailers in the future." (CCMS, para 9.130)*

(Emphasis added)

26. The Commission also stated:

"We intend to further investigate refusals to supply due to low retail pricing.

9.133 As discussed in Chapter 6, we are aware of examples of some suppliers refusing to supply retailers where they are concerned that the retail prices being offered are too low, or indicating that they are only willing to supply if a grocery retailer does not undercut the retail prices set by other grocery retailers of the supplier's products. This may be due to:

9.133.1 direct pressure from grocery retailers;

9.133.2 unilateral actions by suppliers, due to concern about the possible response from major grocery retailers; or

9.133.3 unilateral action by suppliers for other reasons.

9.134 Refusal to supply due to low retail pricing could potentially breach sections 37 and 38 of the Act, which prohibit the practice of resale price maintenance. It could also breach section 36 of the Act, to the extent that a refusal to supply reflects the influence of a major grocery retailer with substantial market power." (CCMS, p410)

27. In respect of strategic mergers, the Commission also noted:

> *"some **submitters have raised historical strategic acquisitions (and attempts at strategic acquisitions) as impacting on competition in the grocery sector**. … **Any further attempted acquisitions would be subject to section 47 of the Commerce Act,** as well as the clearance and authorisation regime set out in sections 66 and 67. … we recommend that suppliers and retailers closely review the compliance of any proposed acquisitions with the Commerce Act…" (CCMS, paras 9.144-5)*
>
> *(Emphasis added)*

28. Logically, procurement of key staples from its retail competitors' wholesale arms is unlikely to deliver pricing that allows material undercutting of those competitors' own retail pricing. Wholesale supply competitors are also unlikely to facilitate a retailer stocking a limited range of SKUs, as TWG found when Sanitarium refused to supply it with Weet Bix.

29. It is clear, based on the Commission's findings in the CCMS and the market evidence of Sanitarium's conduct since the passage of the GICA, that despite the passage of the GICA the Commission cannot exclude a real chance that conduct described in the CCMS will remain a barrier to entry and expansion. This conduct is more likely to be made worse by the proposed strategic merger, based on an orthodox application of conglomerate effects tests.

30. Even if it were true that there is no respect in which FSSI and FSNI (and their interconnected and associated entities) could compete in the counterfactual, the Commission cannot exclude a real chance that the merger would give rise to a substantial lessening of competition in wholesale and retail grocery markets through conglomerate and coordinated effects.

Rationale for the merger (Claim 2)

31. When the Commission considers the rationale for the merger, it will be important to check the track record of FSNI in delivering on similar claims. On 1 September 2013, Stuff reported Foodstuffs Wellington and Auckland merger would be "good for customers".[4] In that article, the following claims were made about the benefits of the merger. A retrospective check of what occurred in the years following suggests that the claims were materially not made out.

32. **Claim:** Customers and members would benefit from all operations running under one IT system and integration of back office functions, there would be improved support and service from day one, and the full benefits of the merger were expected to be realised during the following two years.

    Fact check:

    - The integration of systems was slow, and it is unclear whether a truly integrated system now exists across FSNI.
    - Integration of systems, including the roll out of a new IT system, were initiated in financial year 2013/2014 with the intention of creating "one Foodstuffs" way of working by standardising processes and systems (FSNI 2015 Concise Annual Report (**2015 Report**), p7).

[4] https://www.stuff.co.nz/business/9107913/Foodstuffs-merger-good-for-customers

- Consolidation and extension of the programme of work to integrate the legacy businesses and drive standardisation and efficiency in financial processing was still a key feature of the 2016 financial year (FSNI Concise Annual Report FY2016 (**2016 Report**) p26).

- The core part of the integration of IT systems, a roll out of the SAP system in all stores, was deployed in stages, with the system in all PAK'nSAVE stores by 2018, all New World stores by 2019, and Four Square Stores in 2020 (FSNI's 2018, 2019 and 2020 Concise Annual Reports, p17, p16 and p77 respectively).

33. **Claim:** Foodstuffs would be able to launch online grocery delivery that Countdown was already offering in 2013.

    Fact check:

    - This was slowly, and incompletely, delivered. FSNI's New World stores launched click and collect and online deliveries in 2017 (CCMS, para 3.186). As at date of the CCMS in 2022, FSNI's PAK'nSAVE customers only had a click and collect option, with no options for home delivery and FSNI's Four Square stores did not offer any online purchasing options (CCMS, para 3.187).

34. **Claim:** Systems integration would mean improved efficiencies and savings which would translate into better services and lower prices over time and benefits will far outweigh the costs.

    Fact check:

    - Significant capital expenditure was invested in IT development, including the roll out of a core SAP system discussed above.

    - As at 2018, FSNI stated that increased efficiencies have partially offset the increased running costs of the upgraded infrastructure platform and the significant one-off spend of bringing SAP to stores and deploying online (Concise Annual Report for FSNI Year ending 1 April 2018 (p15)).

    - Increases of distribution of profits to FSNI members was celebrated in its annual reports, as opposed to decreased prices (2015 Report, p6 and 2016 Report, p6).

35. **Claim:** The merger was about growth, as every new PAK'nSAVE created up to 200 jobs and every New World, 100 new jobs.

    Fact check:

    - The merger did not appear to offer growth, or significant amounts of new jobs. Comparing 2014[5] to 2023[6], FSNI has 395 more employees and 23 fewer stores.

[5] In 2014 there were: 1,900 employees, 2 support centres, 8 distribution centres, 355 stores (40 PAK'nSAVE, 98 New World, 205 Four Square, 8 Gilmours and 4 Toops wholesale stores that employ 22,000 people): FSNI's Concise Annual Report 2014.

[6] In 2023 FSNI has: 2,295 employees, 3 support centres, 2 distribution centres, 4 cross dock depots, 332 stores (45 PAK'nSAVE, 108 New World, 172 Four Square, 7 Gilmours): Application, at 26 and Figure 3.

- The first annual report after the merger noted a reduction in salary and direct employee costs (2015 Report, p4).

36. **Claim**: The company's profitability was not expected to change, it would sell more.

    Fact check:

- This did not appear to come to pass as between 2015 and 2023 profit has increased off a lower revenue base:

    (a) FSNI's revenue in 2015 was $6,238,889,000, gross profit was $498,363,000, and net profit was $18,381,000 (2015 Report).

    (b) FSNI's revenue in 2023 was $4,299,346,000, gross profit was $913,408,000 and net profit was $44,944,000 (Consolidated FY23 Financial Statements of FSNI).

The GICA (Claim 3)

37. The parties assert that:

    > *"Key market developments since the final report of the Market Study have included increased retail competition, as well as wholesale supply (which is expected in turn to lead to increased retail competition) under the quasi-regulated wholesale supply regime" (Application, para 58)*

38. The Application provides no data to support the suggestion of increased retail competition. While there are 74 pages of submission, including diagrams, there are no customer surveys or referenced public market reports (at least in the public version) to support any of the assertions of absence of competitive effects.

39. The Application simply asserts that:

    - "the efficiencies will be shared with customers in the form of lower prices at the checkout and lower prices to customers under the wholesale quasi-regulatory regime." (119);

    - the GICA regime "should" result in more retail competition, as well as a "more general increase in retail competition", with the "Commission's ongoing role in monitoring and promoting competition" that "should" be expected to ensure significant pressures to ensure the pass through of savings and efficiencies (120); but

    - the Commission need not consider whether the efficiencies would be passed on, because regardless of the efficiencies there is no adverse effect on competition.

40. In summary, the parties say that taxpayer funded enhanced regulatory oversight "might" (and might not) force some of the savings of the merger to be passed through to New Zealanders. The Application suggests that the Commission does not need to analyse that further because the existing situation, where the parties do not to compete, means the Commission is not required to consider that question anyway. TWG considers that the Commission can, and should, consider these issues.

Summary

41. TWG is concerned that it would negatively impact the consumers of Aotearoa if the Commission:

- [ ] [ ] and
- then also agreed that it need not investigate whether efficiencies will be passed through to customers and suppliers; and
- found that any potential issues would be neutralised by a regulatory regime under which the Commission could act – without accounting for the public cost of more extensive regulatory oversight and intervention than might otherwise be required [ ] [ ] [ ]

Next steps

42. TWG does not have the benefit of information that is not in the public domain. To assist the Commission's process, however, it has identified information that it is submitted warrants closer scrutiny in the clearance process. Suggested lines of inquiry are set out in Appendix 1 to this submission.

43. TWG remains available to assist the Commission in its investigation as helpful.

[redacted]

Erin Vercoe, General Counsel

The Warehouse Group

Appendix 1: Relevant Questions

[ ]

1. [ ]
[ ]
[ ]
[ ]

2. The Application states that there is not expected to be any merger-specific change in competitive strategy associated with the acquisition of groceries (132). FSNI and FSSI submit that the existing close relationship between FSNI and FSSI materially limits the potential effect of the proposed transaction (46).

   (a) [ ]
   [ ]
   [ ]
   [ ]
   [ ]
   [ ]
   [ ]
   [ ]

   (b) **Question:** Do any of FSSI, FSNI or Foodstuffs NZ's projections contemplate any change in volumes of wholesale purchases? In particular, do they model growth in any of the banners, or wholesale operations, facilitated by the merger?

   (c) **Question**: Do any of FSSI, FSNI or Foodstuffs NZ's projections contemplate procurement synergies? Do those include cost synergies arising from a reduction in the price of groceries acquired for wholesale supply?

3. Even where FSNI and FSSI currently deal separately with the same supplier for nationwide supply, the Application suggests that the only change would be that one contract would be in place, rather than two and the merged entity's overall bargaining power will not be greater because they don't currently compete in relation to the share of supply (132.3).

   (a) **Question:** Do FSNI and FSSI currently negotiate together on every wholesale supply arrangement? What agreements do they have about negotiating together? What practices do they engage in that leads to a lack of competition between them?

Quality competition and efficiencies

4. FSNI appears to be quicker to innovate than FSSI. For example, FSNI launched online shopping for New World in 2017 and FSSI has only very recently launched an online offering to be rolled out by the end of 2022 (CCMS, para 2.79).

(a) **Question:** How can the Commission be confident the merger will not reduce the quality or pace of innovation of FSNI's offering to the public (given that FSSI appears to be slower to innovate)?

5. The Application states that efficiencies will be shared with customers in the form of lower prices at the checkout and lower prices to customers under the wholesale quasi-regulatory regime (119) which will in turn result in more retail competition (120).

(a) **Question:** How can the Commission be confident the efficiencies provided by the merger will not give the merged entity a profit buffer to be able to withdraw from low margin areas and focus on growing its footprint in other more profitable areas to saturate the market with Foodstuffs branded stores? Are store closures or new stores modelled? If so, could the merger result in small markets left without a supermarket?

(b) **Question:** How can the Commission be confident that efficiencies will in fact be passed on to customers?

Regulatory compliance

6. At the time of the CCMS, more than two thirds of FSNI's Four Square stores could not offer unit pricing, as they do not have appropriate software (CCMS, para 9.226.5).

(a) **Question**: will the merged entity be prepared and equipped to comply with the existing, and future, regulatory regime?

(b) **Question**: Will any failures in compliance impact the public through the cost of an increased need for input from the regulator (via direct cost to the taxpayer or regulatory compliance costs passed on to customers from the retailers)?

Competition issues identified in the CCMS

7. The merged entity will be a similar size and cost structure to Woolworths (SOPI, para 44). The CCMS found that:

- Under current market conditions, there is little prospect of new or expanding rivals being able to achieve the scale and geographic coverage required to compete effectively with the major grocery retailers (p189).
- Limited geographic and network coverage of other retailers reduces their ability to compete with the national and regional (or island-wide) pricing and acquisition strategies of the major grocery retailers (4.101).
- Cost disadvantages generated by the inability of other retailers, and entrants, to access economies of scale are currently and are likely to continue to remain a significant factor impacting on entry and expansion (6.121).
- In many cases suppliers are likely to be more dependent on the major grocery retailers than the retailers are on particular suppliers (8.65).

(a) **Question:** will consolidation of the supply and distribution networks of FSSI and FSNI make the barriers to expansion caused by the saturation and scale of the major grocery retailers worse (including the power imbalance with suppliers)?