COMMERCE COMMISSION

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Reasons for The Warehouse acquisition declines

The Commerce Commission has released its reasons for declining to grant clearance to the three Foodstuffs co-operatives or to Woolworths Limited to acquire up to 100% of the shares in, or assets of, The Warehouse Group Limited.

On the 8th of June the Commission declined to grant clearance for either acquisition, on the basis that it was not satisfied that either of the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in relevant markets.

Both applicants have lodged appeals against the decisions in the Wellington High Court.

Commerce Commission Chair Paula Rebstock said today that the Commission declined the applications because New Zealand's supermarket retail market is already highly concentrated, and a reduction of players from three to two would substantially reduce competition, to the detriment of New Zealand consumers.

"Without the competitive threat offered by The Warehouse, Foodstuffs and Woolworths would not face the same incentives to reduce prices, and increase quality, service, and innovation" says Ms Rebstock.

"New Zealand's supermarket retail market is highly concentrated by international standards."

"There are high barriers to entry in the supermarket retail market, as evidenced by the fact that, apart from The Warehouse, there has been no new entry into that market for 20 years, other than through acquisition."

“Before The Warehouse’s entry to supermarket retailing, Foodstuffs and Woolworths operated in a duopoly,” Ms Rebstock says.

“The purchase of The Warehouse by either company would return the markets to that state.”

Ms Rebstock says The Warehouse is uniquely placed to compete with the supermarkets because of its existing property portfolio, extensive distribution networks and established brand. The Warehouse would also have a significant advantage in being able to offer grocery and general retailing under one roof.

“The Warehouse already has the locations and the infrastructure to enable it to compete with Foodstuffs and Woolworths,” says Ms Rebstock.

The Warehouse has opened Warehouse Extra “supercentres” in Whangarei and Auckland (Sylvia Park) that offer grocery and general retailing under one roof. It has plans for further Warehouse Extra stores, the next one opening in Te Rapa, Hamilton.

“Overseas experience shows that such supercentres can be highly successful, and result in increased competition and lower prices for consumers,” Ms Rebstock says.

Supercentres have been successful in markets in the UK, Europe, Asia, North America and South America. One study showed that grocery prices in the supercentres of US retailer WalMart were 15-25 percent lower than prices in nearby supermarkets.

“The Commission’s view is that The Warehouse, both as an actual competitor in the local markets where it has opened supercentres, and as a potential competitor in markets where it might open more new supercentres, brings an important new source of competition.” Ms Rebstock says.

Ms Rebstock says the Commission would not be commenting further on the matter while appeals of the decision were before the High Court.

Executive Summary

Background

Applications. On 21 December 2006 the Commission received an application from the three Foodstuffs co-operatives seeking clearance to acquire up to 100% of the ordinary shares in The Warehouse Group Limited. On 17 January 2007 the Commission received an application from Woolworths Limited seeking clearance to acquire up to 100% of the shares in, or assets, of The Warehouse Group Limited.

Companies' share of NZ supermarket sales. On an aggregated basis, Foodstuffs accounts for an estimated 56% of total New Zealand supermarket grocery sales, and Woolworths accounts for an estimated 44% of total New Zealand supermarket grocery sales.

Effects of duopolies. Duopolies protected by high entry barriers impede competitive outcomes in two main ways: by removing competition constraints leading to an increase in market power of the remaining firms acting independently (non-coordinated effects), and/or by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).

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Executive Summary

EXECUTIVE SUMMARY

Introduction

E1. The Commerce Commission (Commission) received separate applications from Foodstuffs (Auckland) Limited, Foodstuffs (Wellington) Co-operative Society Limited, and Foodstuffs South Island Limited, (collectively Foodstuffs) and (separately) Woolworths Limited (Woolworths) seeking clearances to acquire The Warehouse Group Limited (The Warehouse). The issue for the Commission is whether it is satisfied that either of the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in any market. The Commission has prepared one set of reasons for its decisions declining these applications because the issues raised by both applications are similar.

E2. The Commission must assess whether there is a real and substantial risk that there will be more than a minimal lessening of competition.[1] The Commission compares two situations: one with the acquisition proceeding (the factual), and one without the acquisition (the counterfactual). The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in a market between these two situations.

E3. The Commission has declined the applications as it is not satisfied that the acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in a number of local supermarket markets.

Background

E4. These Foodstuffs entities are regionally based cooperatives. Supermarkets under the Pak'n Save and New World are owned and operated by cooperative members, and operate throughout the country. Cooperative members also operate convenience stores. At the wholesale level, Foodstuffs distributes groceries throughout New Zealand.

E5. Woolworths is an Australian-based company that acquired Progressive Enterprises Limited (Progressive) in 2005. It operates throughout New Zealand, 150 supermarket stores directly, operating under the Foodtown, Countdown and Woolworths banners, as well as coordinating an additional 48 franchise supermarket stores operating under the Fresh Choice and Super Value banners..

E6. The Warehouse operates throughout New Zealand some 85 stores that sell general merchandise, toys, apparel and a range of other products, plus 43 stationery stores. It has an extensive distribution network to service its stores.

E7. In 2002, the markets for supermarket retailing concentrated into two competing operators when Progressive purchased Woolworths NZ. Until recently, consumers' choice of supermarkets has been limited to one or other of the businesses controlled by Foodstuffs or Woolworths. In the larger population centres, consumers may have the choice of stores of both groups, but in lower population areas there may only be a banner of one group represented.

E8. In 2006, The Warehouse introduced the supercentre concept to New Zealand at Mt Wellington (Sylvia Park) and Whangarei. Modelled on supercentres or hypermarkets operating overseas, the Warehouse Extra stores provide shoppers with the convenience of purchasing general merchandise, apparel, and a wide range of groceries and food items commonly found in

[1] *Air New Zealand & Qantas Airways Ltd v Commerce Commission (No. 6)* (2004) 11 TCLR 347; *Commerce Commission v New Zealand Bus Limited* (2006) 11 TCLR 679; *Fisher & Paykel Limited v Commerce Commission* [1996] 2 NZLR 731; *Port Nelson Limited v Commerce Commission* [1996] 3 NZLR 554.

supermarkets in the one store. The Warehouse intends to run its Extra format for some time to see if it will succeed, modifying the format as necessary to fit New Zealand conditions. If successful, it will roll out further supercentre stores. It also has plans to convert other existing stores, or to construct new stores in other locations. The next “Extra” store is due to open in Te Rapa (Hamilton) in late 2007.

E9. The addition of the Warehouse Extra stores provides, and would in the future provide, consumers in those localities with a third choice of an independently owned supermarket with a different service offering.

E10. The supercentre concept is only in an embryonic testing stage in New Zealand but the business model – which differs from that of traditional supermarkets – has had widespread success internationally. It takes time for a supercentre operation to develop to meet the conditions applicable to a particular area. Wal-Mart is recognised as a leading operator of supercentres. In the United States, Wal-Mart started in a very small way, opening only nine supercentre stores over its first five years and then 295 stores in the following five years. One study showed that grocery prices in the US supercentres were 15%-25% lower than supermarkets in the same area.

E11. The Warehouse has a number of stores suitable for conversion to the “Extra” format. It also owns additional land on which food and general merchandise stores could be constructed, is an established and well-recognised brand, and has an established distribution network. The Commission considers that it is uniquely placed as a potential competitor to the supermarkets, regardless of whether or not the “Extra” concept is fully deployed as planned. For other firms that may consider competing against supermarkets, access to suitable sites would be particularly problematic.

E12. The acquisition by Foodstuffs or Woolworths would at this stage of development result in The Warehouse ceasing to be an existing supermarket retailer in a small number of regions, and a potential supermarket retailer in a number of other regions. The benefits of the innovative supercentre concept introduced by a third maverick player would be lost.

E13. The acquisition would foreclose the potential for The Warehouse to be used by any other independent party as a springboard to entering the market.

E14. The likely competition effects of either Foodstuffs or Woolworths owning The Warehouse are very similar.

The Relevant Markets

E15. For its analysis the Commission first must define the relevant markets affected by the proposed acquisitions in order to assess the likely competition effects. The Warehouse is principally engaged in the retailing of general merchandise, and recently, the retailing of groceries in its Warehouse Extra stores. Supermarkets are principally engaged in the retailing of groceries.

E16. The Commission has found that the main reason consumers shop in supermarkets is that they value the one-stop-shop concept. Convenience stores and specialist stores, for example, butchers, greengrocers and bakeries provide alternative sources of those products sold in supermarkets, but they do not provide a satisfactory alternative to supermarkets for most consumers seeking to purchase a wide range of grocery items at the one time, such as when weekly shops are undertaken.

E17. The Commission has concluded that supermarkets operate within a discrete product market for retailing groceries. This is consistent with previous decisions, and with overseas competition cases. It is recognised, however, that supermarkets are differentiated. Each banner has a different price/service mix.

E18. In order to frame the geographic boundaries of local markets, the Commission has assumed that to avoid price increases of around 5% consumers are likely to travel up to around 5 km to an alternative supermarket, and depending on the locality may travel further. Accordingly the principal focus of the Commission's analysis in this case is an approximately 5 km radius around each existing and planned Extra store. The Commission recognises that neighbouring supermarkets (and supercentres) inside this area are likely to be closer substitutes than those further away.

E19. The applicants and The Warehouse purchase grocery items from wholesalers and other suppliers located throughout New Zealand giving rise to a national wholesale market for the supply of groceries.

E20. The Warehouse's current primary focus is the retailing of general merchandise. The Commission has considered whether there is likely to be any competition concerns in the markets for general merchandise. Foodstuffs and Woolworths sell a small range of general merchandise through their supermarkets, constituting a small percentage of their sales revenue. However, as there are several other major general merchandise operators, the Commission does not consider that competition in general merchandising will be affected in a real way. Consequently, the Commission has decided not to analyse these markets in this case.

E21. The Commission concludes that the relevant markets for the consideration of the applications are:

- the markets for the retailing of grocery items in supermarkets, incorporating local markets not less than 5 km in radius from a current or proposed Warehouse Extra in:
  - Mt Wellington, Whangarei and Te Rapa;
  - a number of locations that are confidential; and
  - other regions where there is a credible potential for a roll out of a supercentre.
- the national market for the wholesale supply of groceries.

Factual and Counterfactual

E22. When assessing the competitive impacts of an acquisition, the Commission assesses the likely situation with the acquisition (the factual) with the likely situation without the acquisition (the counterfactual).

E23. Under the factuals for each acquisition The Warehouse would be under the ownership and control of Foodstuffs or Woolworths. Significantly, in relation to the supermarket markets, The Warehouse Extra would cease to be an actual or potential competitor, and only two supermarket groups would operate.

E24. Under the counterfactual for each acquisition, The Warehouse would remain independent from both Foodstuffs and Woolworths. Included in these counterfactuals is the continued operation of the "Extra" supercentres, and their potential to be rolled out in other regions. Accordingly, there would be three independent supermarkets operating, or having the potential to operate, in the supermarket markets with The Warehouse providing a different and innovative type of offering.

Competition Analysis

E25. Woolworths and Foodstuffs operate supermarkets throughout New Zealand. Over the country as a whole, Foodstuffs collectively accounts for 56% of supermarket sales and Woolworths 44%. In all regions, the markets are highly concentrated, and only in Mt Wellington and Whangarei do Foodstuffs and Woolworths face a third competing supermarket, The Warehouse Extra. The applicants will shortly face competition from The Warehouse in Te Rapa, Hamilton.

E26. In Mt Wellington, Whangarei and Te Rapa, The Warehouse is an existing competitor, or planned competitor, and its acquisition by either applicant would see the disappearance of the only third competitor with no other likely entrant in the foreseeable future.

E27. In Mt Wellington, there are six supermarket banners in operation: two owned by Foodstuffs, three by Woolworths and a Warehouse Extra. In the first eight months since it opened, the Warehouse Extra has accounted for a reasonable volume of total market sales. In the Whangarei market there are three Foodstuffs supermarkets, three Woolworths supermarkets and a Warehouse Extra. In the first four months since opening, The Warehouse Extra has accounted for a similar sales volume as that in its Mt Wellington store.

E28. The Commission considers that the sales figures for The Warehouse Extra do not fully reflect the full extent of the competitive effect The Warehouse will have in these markets, which would be lost in the factual situations. The figures may well come to understate the impact, particularly as The Warehouse management refines the Extra concept and operations, and as they move out of the shadow created by the acquisition proposals.

E29. In principle, the removal of an existing competitor or potential competitor may not raise a concern if further entry by another operator is likely within a reasonable time frame and with sufficient scale. However, new entry seems very unlikely in the case of supermarket markets.

E30. The Commission considers that there are high barriers to new entry into the supermarket markets. The barriers include access to suitable sites, obtaining resource consents and achieving sufficient scale in supermarket retailing. Major overseas operators have indicated to the Commission that they have no plans to enter the New Zealand markets; nor have potential domestic operators indicated any intention or likelihood of entering.

E31. The presence of high barriers to entry is also borne out by there being no other new entry by a supermarket operator for over 20 years, even since the consolidation in the markets that took place in 2002.

E32. Both Foodstuffs and Woolworths have indicated that suitable sites for their expansion are difficult to find. This supports the view that access to suitable sites would be a problem for a new entrant.

E33. The Warehouse is a recent entrant in Mt Wellington and Whangarei, and a near entrant in Te Rapa, and is the only potential entrant into the supermarket markets elsewhere. This is because it is in the unique position of being able to overcome the high barriers to entry into supermarket retailing, by virtue of its innovative track record in general merchandising, its existing infrastructure, a number of existing sites with food consents, a landbank of sites able to be developed in the future, a distribution system, and an established brand. The Warehouse is also able to achieve economies of scope (from the joint supply of general merchandise and groceries) to offset its lack of scale in supermarket retailing, in comparison with the incumbent supermarkets, at least during the early years.

E34. The supercentre concept is proven overseas, works more often than not, and is directly based on the combination of groceries with general merchandise under one roof. Other existing large retailers would be much less able to provide this combination from their existing operations and infrastructure.

E35. Foodstuffs and Woolworths compete against one another on everyday grocery item prices, by advertising special prices and offering different product ranges and other incentives, such as fuel discount vouchers and loyalty schemes. However, they operated in a duopoly before Warehouse Extra entered some markets, and would do so again if either proposed acquisition were to proceed.

E36. Duopolies protected by high entry barriers are not conducive to competitive outcomes. While some competition will occur between the two firms, such market conditions do not guarantee the consumer benefits that are to be expected when competition is fully effective.

E37. Both applicants argued that The Warehouse Extra's supercentres do not pose a competitive threat, and that the concept will likely fail because The Warehouse does not share their buying power advantages, is therefore not price competitive, and is failing to attract shoppers. The Commission does not share this view. The Warehouse is a major corporate with a successful track record of expansion and innovation. The Warehouse will trial the "Extra" concept for some time. Overseas, the introduction of supercentres in various countries has seen a period of establishment and adaptation followed by major growth. The Commission considers it is not for the Commission to determine whether the "Extra" concept will succeed or fail. Rather it is for the market to determine whether this venture will ultimately be successful.

E38. Foodstuffs and Woolworths have pointed out that the supercentre model has not been successfully adopted in Australia, the country which is most economically and culturally similar to New Zealand. However, the Commission notes Coles Myer's announcement in November 2006 that it intends to open 80 supercentres in Australia. It described the format as the fastest growing format in the world.

E39. The Warehouse is already price competitive. While its existing stores' prices are within the discount/full service price range, its prices are not currently the lowest, nor are they the highest. The Commission notes that it is not necessary to sell at the lowest price to be a very effective competitor. If The Warehouse provides a combination of offering, service and price that appeals to consumers, it would provide competitive constraint in the market. The

Warehouse has a product in the Warehouse Extra that is clearly differentiated from its supermarket competitors by offering a full range of groceries and general merchandise under the one roof.

E40. The Commission considers that The Warehouse brings an important competitive value to the markets as a "maverick" new entrant. That is, it has provided a non-typical supermarket with a different business model from that of Foodstuffs and Woolworths. It is also strongly motivated to succeed with its Warehouse Extra and thereby increase its general merchandise sales. It is likely to have an impact on competition out of proportion to its market size because it offers an innovative, new shopping service to consumers.

Competitive Effects

E41. Acquisitions that result in such highly concentrated markets may lessen competition in two main ways:

- by removing competition constraints that lead to an increase in market power of the remaining firms acting independently (non-coordinated effects); and/or
- by changing the nature of competition in a way that makes tacit or express coordination between firms more likely, effective and stable (coordinated effects).

E42. The Commission considers that in the factual both the merged firm and the other remaining supermarket group would have less incentive to compete vigorously with each other due to the loss of the competitive constraint of The Warehouse (non-coordinated effects). The acquisition of The Warehouse would allow the acquirer to raise prices, knowing that customers lost to The Warehouse would be 'recaptured' within the combined entity. In addition, the loss of an innovative competitor would also remove dynamic competitive pressure on Woolworths and Foodstuffs over time to improve their offerings by further reducing prices, improving service and quality or being more innovative.

E43. The Commission also considers that either of the proposed acquisitions would make coordination between Foodstuffs and Woolworths more likely, effective and stable in the factual than in the counterfactual (coordinated effects). Woolworths and Foodstuffs sell many similar grocery lines on which they could coordinate prices. The proposed acquisitions would restore a duopoly of two evenly-matched competitors that would make coordination easier. With the elimination of The Warehouse, there are unlikely to be any other factors that would destabilise coordination, such as another maverick firm, or a competitive fringe. The incumbent supermarkets would be able to detect any deviation from coordination because they constantly monitor each other's prices, and effective retaliation need only be in the form of the risk of temporarily abandoning the coordinated practices and reducing prices/ margins to pre-coordination levels.

E44. These adverse effects are likely to materialise not only in the areas where The Warehouse has already rolled out, or plans to roll out, its Extra stores, but also in those regions where there is a credible potential for The Warehouse to roll out the supercentre concept over time. In contrast, in the counterfactual, the presence of an independent innovative maverick like The Warehouse is likely to provide an effective competitive constraint on both Woolworths and Foodstuffs, and substantially reduce the likelihood of coordination.

The National Market for the Wholesale Supply of Groceries

E45. Both Woolworths and Foodstuffs are major buyers in the market for the wholesale supply of groceries. The suppliers are the grocery manufacturers, of which there are many, both large and small, most tending to specialise in limited ranges of goods. Apart from the two supermarket operators, other buyers include independent dairies, petrol stations and other members of the route trade, although many of these are supplied by Foodstuffs wholesaling operations. The Warehouse has entered this market as a buyer, by virtue both of its selling of a limited range of dry goods through its conventional stores, and more recently by offering a wider range of groceries through its Extra stores.

E46. Buyer power of the supermarket chains, insofar as it exists that is not countered by supplier power, could impact on market outcomes in various ways, and could in some circumstances adversely affect competition and harm consumers:

- Large buyers could extract lower wholesale prices from suppliers. If these buyers also have market power over consumers, they could maintain higher retail prices and pocket the difference to earn higher profits. However, lower wholesale prices could also be passed on to customers in lower retail prices, if retail competition were effective.
- The pressure to lower wholesale prices could impact on suppliers in various ways. They might become more efficient; they might attempt to raise wholesale prices to other retailers lacking in buyer power; or they might be discouraged from making investments in process and product innovation, as well as in maintenance, if expected returns are reduced.
- Consumers could be harmed by higher retail prices and a lower rate of innovation and product quality, or benefit from lower prices and improved efficiency and investment.

E47. The presence of buyer market power is not always easy to determine, and its impact on competition in the wholesale groceries market could vary, depending upon the circumstances of each supplier of the thousands SKUs carried by supermarkets.

E48. Without examining the position of each and every one of the many suppliers to supermarkets, it seems unlikely that the loss of The Warehouse as an independent grocery buyer would have a noticeable effect on the buyer power of the incumbents. The Commission recognises that, in the future, the Warehouse's share of purchases in the wholesale market could grow as it rolls out more supercentres. However, because the market for the wholesale supply of groceries is national, The Warehouse's share of purchases is likely to be far lower than its share of retailing in local supermarket markets. In any case, in the future, it is far from certain that any increased ability for purchasers to negotiate lower prices from suppliers would be harmful to competition, especially if these lower prices are passed on to consumers.

Conclusions

E49. In respect of the local supermarket markets, the Commission has concluded that the loss of existing and potential competition from an innovative firm in circumstances where it is the only likely entrant for the foreseeable future, and the other resulting foreclosure effects, will lead to a substantial increase in market power of the remaining incumbent supermarkets. As a result of the loss of this significant competitive constraint in the factual, there is a real risk that prices will be materially higher, and quality, service and innovation materially lower, than in the counterfactual through either or both non-coordinated or coordinated effects. Having reached these conclusions, the Commission cannot be satisfied that the proposed acquisitions will not have, or would not be likely to have, the effect of substantially lessening competition in the relevant supermarket retail markets.

E50. The Commission is satisfied that, should the proposed acquisitions proceed, they will not have, or would not be likely to have, the effect of substantially lessening competition in the national market for the wholesale supply of groceries.

E51. The Commission has declined to give a clearance to either Foodstuffs or Woolworths to separately acquire up to 100% of the ordinary shares of The Warehouse.