Supermarket divestment options and cost benefit analysis

Summary report

4 October 2022

Notice

Key points

Our brief: analyse divestment options in the New Zealand grocery sector

- Coriolis, Sense Partners and Cognitus ("the consultants") were engaged in late July 2022 by the Ministry of Business, Innovation and Employment to explore options related to divestment in the New Zealand grocery sector as a means of lifting competition and improving outcomes for to consumers in the grocery sector.
- We were tasked with providing insights into the following five research questions:
  1. To what extent would retail divestment in the New Zealand grocery sector improve competition?
  2. What are the critical success factors in achieving grocery sector divestment in New Zealand and how would we know that divestment had been successful?
  3. What divestment options should the Government consider (i.e. what could or should be divested and how, which is the preferred option and why)?
  4. What are the estimated quantified costs and benefits of the options in the short and longer term, and what are the distributional impacts of those costs and benefits?
  5. What are the risks associated with these options and how could these be mitigated?

This joint report summarises our key findings

- Detailed analysis of questions 1, 2, 3 and 5 can be found in this document, including the attached exhibits.
- Additional supplementary material is provided in Coriolis (2022b). A technical report outlining the cost-benefit analysis (CBA) for question 4 is provided in Sense Partners and Cognitus (2022).
- The consultants collaborated closely throughout the research period and this summary report reflects our collectively agreed perspectives on the five research questions.

Key takeaways

- Our analysis suggests supermarket divestment *could* be net beneficial, but only if several key factors aligned well, and several key risks could be adequately mitigated. And even then, any net benefits are not enjoyed equally by all households.
- In our view, on balance, the risks are more on the downside than the upside. This is because:
  - Divestment of the nature being considered here is unprecedented in New Zealand. The risks of unintended consequences are not trivial.

  - There are significant implementation challenges to be overcome to increase the chances of a positive outcome for consumers, not least those related to government seeking to direct Foodstuffs' hundreds of owner-operators to change their businesses.
  - Likely to prejudice international relations

- Further detailed analysis is required to provide a more definitive assessment of divestment's merits. Our suggestions for such analysis are provided in section 8 of Sense Partners and Cognitus (2022).

1. To what extent would retail divestment in the New Zealand grocery sector improve competition?

- The government has proposed and/or put in place a range of initiatives to improve grocery sector competition. Key initiatives include a Grocery Commissioner, a wholesale access regime, and a wide range of other activities.
- These changes are likely to lead to a modest improvement in workable competition, especially for smaller retailers. They should also benefit suppliers.
- While there may be changes at the margin due to these regulatory changes, plus the arrival of Costco, re-emergence of the Warehouse Group as a provider of staple grocery products and growth in online offerings, it seems improbable that these will result in significant structural change.
- Without divestment or the threat of major new entrants, the current duopoly-dominated structure of the New Zealand grocery sector is unlikely to change for the foreseeable future. Without major changes in relevant technologies or consumer preferences, a continuation of trends experienced over the past two decades appears the more likely scenario.
- At a high level and depending on the nature of the regulatory intervention involved, divestment might be expected to lead to an improvement in workable competition in the New Zealand grocery sector.
- Provided the new stores remain viable, consumers would have more choice of banners and types of offerings (across price and non-price features) in areas where divestment occurs.
- Suppliers will have more buyers competing for their products, which should improve their bargaining power and returns, albeit with ambiguous consumer impacts in terms of offerings and prices.

2. What are the critical success factors in achieving grocery sector divestment in New Zealand and how would we know that divestment had been successful?

- The ultimate success of divestment actions can be defined in terms of delivering more enduring and efficient – and hence more workable – competition at the national and local areas (where feasible).
- The success of divestment will also be judged by the clarity and equity of the regulatory process adopted.
- Effective divestment rests on several critical success factors related to the ease of implementation for government and firms.
- Overall, divestment is more likely to be successful if interventions are:
    - Simple to understand, implement and monitor.
    - Equitably applied
    - Supportive of a market outcome with stable and viable competitors
    - Not unduly damaging to existing firms' incentives and property rights.

3. What divestment options should the Government consider (i.e. what could or should be divested and how, which is the preferred option and why)?

- We explored four divestment options taken from the RfQ (Options 1-4) and two additional options designed by the project steering group (Options 5 and 5+). The options are summarised in Table 1 overleaf.
- Based on a commercial assessment of how each option might work in practice and a criteria-based analysis drawing on critical success factors related to the promotion of workable competition, Option 2, Option 5 and Option 5+ were the highest scoring approaches to divestment.
- Options 1, 3 and 4 could all face significant implementation challenges that would materially limit their potential effectiveness in terms of promoting workable competition.
- Based on direction from the project steering group, Option 5 and Option 5+ were selected for quantitative analysis in the CBA.

TABLE 1 SUMMARY OF OPTIONS

	Option	Brief description
1	Government-led	Government-led divestment by the major grocery retailers to a new 'like-for-like' entrant with minimum viable scale at the national level and a presence in the nine major urban centres.
2	Industry-led, national focus	Company-led divestment by the major grocery retailers to meet a government-mandated national market share cap. Retailers would produce a divestment plan for government to approve.
3	Targeted divestment of brands	The divestment by retailers of one or more of their retail banners into a new company with a minimum viable scale at the national level.
4	Wholesale ownership separation	Splitting the ownership of wholesale and retail ownership to ensure new market entrants can access wholesale groceries at the same prices as their competitors.
5	Industry-led, with local market focus: three main players	Government designs a set of rules to ensure sufficient stores are divested to achieve more competitive market structures in local areas with three or more stores, and at a national level by ensuring a third player can achieve sufficient national scale (for instance having around 20% market share). Each major retailer develops a divestment plan based on these rules and submits it for government approval.
5+	Industry-led, with local market focus: four main players	As above, but with the aim of divesting such that *two* additional players can compete at the national level with a minimum of 15% national market share.

Source: RfQ and project steering group

4. What are the estimated quantified costs and benefits of the options in the short and longer term, and what are the distributional impacts of those costs and benefits?

- The costs and benefits of divestment under options 5 and 5+ are compared against a 'No divestment scenario'.
- The No divestment scenario incorporates the effects of recently-announced changes to the supermarket sector in New Zealand.[1] It also includes the entrance of Costco, which will become a small competitor in the market.

[1] Namely regulating Woolworths and Foodstuffs to offer wholesale groceries to their competitors on "fair" and "good faith" terms, should they not do so voluntarily by the end of 2022; banning restrictive covenants on land and exclusive covenants on leases; establishing an industry regulator (the Grocery Commissioner); introducing a mandatory Grocery Code of Conduct; compulsory unit pricing on groceries; and more transparent loyalty schemes.

- These changes serve to improve competition in the grocery sector relatively modestly. We assume the collective market share of all smaller retailers (including Costco and any new entrants) doubles out to 2042, from an estimated 5% to an estimated 10%.
- They also reduce the major chains' profit margins in the No divestment scenario relative to what they would otherwise have been and increase those of smaller retailers.

Option 5 headline results

- Our modelling predicts a very wide range of possible net benefits or costs from Option 5 (see Table 2).
    - The estimated effects range from a net benefit of $4.6 billion to a net cost of $3 billion.
    - The Central case estimate is a net benefit of $0.5 billion.

TABLE 2: IMPACTS ON PRODUCERS AND CONSUMERS, OPTION 5
Present value $2022 millions, discount rate of 5%

		Central	Low	High
Producer impacts	Supermarkets	-$4,926	-$5,470	-$4,500
	Suppliers	$2,264	$3,777	$0
	Total	-$2,661	-$1,694	-$4,500
Consumer impacts	Prices	$3,206	$651	$6,823
	Variety	$0	-$2,018	$2,359
	Total	$3,206	-$1,367	$9,182
Net benefits	Total	$545	-$3,060	$4,682

Source: Sense Partners modelling

- While these net benefits appear large in dollar terms, they represent just 0.15% of the No divestment scenario supermarket sales in the Central case, and -0.9% and 1.3% of sales in the Low and High cases respectively.
- The key reason for this very wide range of results is due to the calculation of potential benefits:
    - In the High case, consumers benefit from lower retail prices and there are no offsetting variable cost increases that reduce these benefits. In addition, consumers benefit from increased variety[2] and choice in a reinvigorated supermarket sector.

[2] In the CBA, gains from variety refer to benefits to consumers of different supermarket offerings resulting from divestment. This is a combination of having more choice of stores/banners in any area and potential changes to the range of products being offered.

  - In the Low case, choice and variety is constrained because of reduced supermarket profitability. Although consumers benefit from lower prices, the effects of competition on prices are limited because costs increase and some of these are passed on to consumers.

- Our Central case falls roughly between these two extremes. There are no gains from variety nor loss of choice. And although some industry costs do increase, consumer welfare improves due to higher competition putting downward pressure on prices.

- Likely to prejudice international relations

- These costs – while difficult to quantify – could potentially turn the positive result in our Central case negative, illustrating how finely balanced the costs and benefits are.[3]

Option 5+ headline results

- Option 5+ offers a lower chance of net benefits, with Central scenario net benefits of $0.1 billion versus $0.5 billion for Option 5, largely due to higher cost increases associated with the establishment of four separate supermarket groups.

TABLE 3 IMPACTS ON PRODUCERS AND CONSUMERS, OPTION 5+
Present value $2022 millions, discount rate 5%

		Central	Low	High
Producer impacts	Supermarkets	-$6,236	-$6,968	-$7,435
	Suppliers	$3,196	$4,636	$2,210
	Total	-$3,041	-$2,332	-$5,225
Consumer impacts	Prices	$2,051	-$416	$6,765
	Variety	$1,093	-$1,009	$2,359
	Total	$3,144	-$1,425	$9,124
Net benefits	Total	$103	-$3,757	$3,899

Source: Sense Partners modelling

- Again the estimated results have a wide range, caused by key assumptions about whether or not regulated divestment will prompt variety gains that are not offset by higher costs that reduce the efficiency of the industry overall.

- Absent benefits from greater variety, the Central scenario for Option 5+ would result in a net cost.

[3] For example, if just one basis point in extra borrowing costs arises because of forced divestment, and that cost is borne across all New Zealand borrowers, this could – indicatively – result in a net cost to New Zealand of around $50 million per year.

- Likely to prejudice international relations

- We note that the implementation challenges related to Option 5+ are far greater than those in Option 5 (which are also significant), as this option is a less 'clean' split and the Woolworths spin-off NewCo would be receiving a very wide range of store types and sizes, often in locations that would be difficult to manage efficiently.

Regional impacts of divestment vary considerably

- Under Option 5’s Central scenario:
    - Larger urban markets have higher amounts of pre-existing competition and see retail price changes of between 0% and -2%.
    - We see larger retail price decreases from divestment in some small markets, between -10% and -16%. These effects occur in areas where supermarket ownership is initially highly concentrated in favour of one major group.
    - Supermarket prices *increase* in small markets where no (or very limited) divestment occurs and cost increases are passed on to consumers without offsetting reductions in store margins.
    - On a regional basis, consumers are worse off following divestment in the West Coast, Tasman, Taranaki, Marlborough and Gisborne. These regions have a high share of local areas with two or less supermarkets, which see no improvement in competition.
- Similar patterns are seen under the Central scenario in Option 5+, with the negative effects on smaller regions being more severe than in Option 5. The same number of small towns enjoy no gains from additional competition as they have less than three supermarkets, but the cost increases across the sector are considerably larger than under Option 5.

Distributional impacts of divestment by household types

- In general, when food prices fall, lower income households gain proportionately more than higher income households, as they spend proportionately more than higher income households on groceries.
- This occurs in Option 5 in areas where divestment occurs. Lower income households benefit relatively more than higher income households.
- However, when we include smaller areas with less than two supermarkets (which absorb the costs of divestment on the major groups, but do not enjoy offsetting competition benefits), the impacts of divestment are less progressive.

- Option 5+ is likely to lead to higher costs and prices in local markets without much pre-divestment competition. Just as they benefit proportionately more from price reductions, lower income households are made proportionately worse off when prices rise.
- Divestment under Option 5+ therefore risks delivering regressive impacts on lower income consumers.
- We have not explored differences in impacts by ethnicity due to time and data limitations. But to the extent that Māori are over-represented in some rural or low-population areas without much supermarket competition, the modelled welfare losses in these areas warrant further analysis.
- These distributional results point to the uneven and complex distributional impacts of divestment options in the grocery sector and highlight potential risks of inequality being worsened in rural and/or small areas without many stores.

Sensitivity analysis: variety gains & supply price assumptions are crucial

- The net benefit results are highly dependent on assumptions related to potential variety gains and changes in supplier prices:
    - For the Central scenario in both Options, if we assume that variety effects are reduced by 0.5% (as a share of supermarket revenue), the results switch from a net benefit to a net cost.
    - Small changes in assumptions about supplier costs also have the potential to change the sign of the Central scenarios for both options, from net positive to net negative.
- These changes underscore that the variety and supply price assumptions have large effects on the estimated net benefits or net costs to society. They warrant more in-depth analysis for future divestment work.
- Other assumptions related to modelling parameters and market share caps have much smaller impacts on the overall net benefits or costs.

5. What are the risks associated with these options and how could these be mitigated?

- The benefits of industry-led divestment should not be oversold. Divestment will not – in-and-of itself – materially change the types of stores operating in the New Zealand grocery sector.
- Instead, divestment will move the game from two major players to three or four players. All will likely still be running traditional supermarkets and some box warehouse stores.
- Key operational risks associated with industry-led divestment include, but are not limited to:

- The risks of implementation proving to be more difficult than anticipated, which could cause challenges for complex and vital grocery supply chains.
- This risk is particularly acute in respect of the many independent owner-operators of supermarkets currently part of the Foodstuffs cooperatives, as well as the owners of SuperValue and Fresh Choice franchises. While Countdown stores are ultimately owned by a single company that can be assumed to control what happens to those stores, the same cannot be said of other stores in the sector.
- Divestment could take much longer than anticipated, and/or be subject to legal challenges, which would lead to uncertainty in the sector.
- The major groups have access to better data than government and could potentially game the system if asked to divest a set amount/type of stores (e.g. divesting the worst-performing ones).
- In Option 5+ in particular, NewCo could struggle to emerge as a viable robust competitor. It inherits a wide range of store types, sizes and banners widely spread out across New Zealand, often in more remote or smaller areas, and its operating model and brand need to be created since it does not already part of an operating chain.

- Other risks relate to:

Likely to prejudice international relations

Caveats and suggested next steps

- The analysis sitting beneath this report is subject to several caveats, the most significant of which was the lack of detailed store-level revenue (and hence market share), cost and profitability data, especially at the local level. In lieu of detailed company data, the CBA was populated with a synthetic data set drawn from publicly available data sources and many assumptions.
- The CBA presented here is not a forecast of what *will* happen in the supermarket sector over the next 20 years. It solely seeks to examine what *might* be the potential costs and benefits of a given set of assumptions related to divestment options, relative to a No divestment scenario. We acknowledge that the entry of major overseas supermarkets or

rapid technological change could materially alter how workably competitive the New Zealand grocery sector becomes in the absence of regulatory change.

- The CBA was completed over an eight-week period. This limited the number of scenarios we could explore and the degree of detail we could go into. The scenarios explored in the CBA were those designed by the project steering group.
- We do not examine any legal matters related to divestment. These were out of scope, as per the Request for Quotation (RfQ), which asked suppliers to focus on "the economic case for divestment, rather than any legislative issues or obstacles associated with a divestment remedy".
- Our analysis is only a possible first step in informing divestment decisions, and further design work, and a full cost benefit analysis, could be undertaken following this study if MBIE sees merit in doing so.
- In our view, the unprecedented nature of the divestment options being considered, and the various commercial and reputational risks identified, warrant additional analysis in slower time, with better data and with greater exploration of the key assumptions required for such an assessment (e.g. gains from variety, productivity benefits from additional competition, impacts on supply prices).
- Such in-depth analysis would reduce the risks of unintended consequences from a significant regulatory move.
- Despite these caveats, our analysis hopefully provides a more informed basis for Cabinet to make decisions in relation to possible next steps regarding divestment, including what further in-depth analysis might be required.

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Objectives and scope

Purpose of report

This document summarises the more detailed analysis provided in the accompanying materials:

(i) Coriolis (2022a), appended to this joint summary report), which provides additional analysis on questions 1, 3 and 5.

(ii) Coriolis (2022b), which provides supporting material and addresses supplementary questions that arose during the project.

(iii) Sense Partners and Cognitus's cost-benefit analysis (CBA) technical report (SP&C, 2022).

Cross-references to those documents are provided in red for readers wishing to better understand more of the thinking and analysis behind the summarised findings presented here.

Where did this project come from?

On 17 November 2020, the Hon Dr David Clark, Minister of Commerce and Consumer Affairs, published a notice under section 51(1) of the Commerce Act 1986 (the Act) requiring the New Zealand Commerce Commission to undertake a study into any factors that may affect competition for the supply or acquisition of groceries by retailers in New Zealand.

The New Zealand Commerce Commission's market study into the retail grocery sector[4] concluded:

1. **New Zealand supermarket profits are high:** Financial returns on average capital employed by major grocery retailers are well above expected normal returns.
2. **Grocery prices are high:** Grocery prices in New Zealand are relatively high by international standards.
3. **Innovation is low:** The New Zealand grocery sector has a lower scale and pace of innovation than might otherwise be expected in a workably competitive market.

The Commerce Commission made 14 recommendations, but these did not include divestment at this stage

The Commerce Commission made 14 recommendations across a range of areas, ranging from prohibiting restrictive and exclusive covenants to establishing a grocery regulator and dispute

[4] https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf

resolution scheme. However, the Commerce Commission was unable to make a firm conclusion about the merits of divestment.

Our summary of the Commerce Commission's findings[5] specifically on divestment are:

1. There are arguments for and against divestment.
2. The Commerce Commission did not have enough information to conduct a cost benefit analysis during its 16-month inquiry.
3. Government should implement the Commerce Commission's other recommendations first before considering divestment.
4. Government should ask the Commerce Commission to conduct further work on the question in three years.

The government requested additional work on divestment

Government accepted the Commerce Commission's findings and recommendations but asked for more work to be completed on retail divestment.

This report provides a more detailed investigation of divestment as a means of improving competition and reducing costs to consumers in the grocery sector. Specifically, the work provides consultancy advice on options for divestment in the grocery sector and the costs, benefits and risks associated with a preferred or best-case divestment option.

What is divestment?

Divestment has a clear meaning in common usage, described by the Cambridge Dictionary as:

> *"The act of selling off a business or businesses."* [6]

In business and finance, the more technical definitions is:

> *"Divesting is the act of a company selling off an asset… Divesting can be seen as the direct opposite of an acquisition."* [7]

What questions are we tasked with answering?

As a result of our tight brief – and our short timeframe – this project is solely focused on evaluating options for divestment. All other possible remedies for promoting more workable competition are out of scope.

This project is tasked with answering five questions. This summary report is structured around those questions.

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[5] p438-439 of https://comcom.govt.nz/__data/assets/pdf_file/0024/278403/Market-Study-into-the-retail-grocery-sector-Final-report-8-March-2022.pdf
[6] https://dictionary.cambridge.org/dictionary/english/divestment
[7] https://corporatefinanceinstitute.com/resources/knowledge/deals/divesting/

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Context in which divestment is being considered

Why do we care about supermarket competition?

New Zealand households spend around 14% of their household expenditure on retail food and beverages and 20% on all food (at home and in restaurants, etc). Most (78%) 'at home' food purchased at retailers is sold by supermarkets.

Beyond food, supermarkets are the leading source of a wide range of non-foods products for most households, ranging from household cleaners to pet food, from baby needs to consumer healthcare.

What is a supermarket?

The official New Zealand definition of supermarkets, grocers and dairies is relatively clear, though it has changed with time. The key definitions are in the Australia & New Zealand Standard Industrial Classification (NZSIC) 1996 and the New Zealand Sale of Liquor Act 1989.

From these two official definitions, we define a supermarket as a store in which:

- A full shop is possible as the principal business of the store is the "sale of main order household foodstuff requirements".
- Groceries, fresh fruit and vegetables and fresh meat are sold.
- Products are organised into distinctive departments
- Some form of prepared foods ("deli") department exists.
- 10 or more Full Time Equivalent (FTE) workers are employed
- The floor area is at least 1,000m^2.

Supermarkets sell a wide range of products across a wide range of categories, including perishables, shelf-stable foods and non-food products.

The size and composition of the competitive landscape for supermarkets changes depending on sector definitions adopted. This project is focused on national chain supermarkets and grocery stores.[8]

[8] However, we acknowledge the presence of other providers, such as Asian grocery stores, Costco, online supermarkets, etc. These are incorporated in our CBA as a catch-all 'Other' store type.

How do supermarkets compete?

Too often discussion of supermarkets is simplified down to price as if nothing else matters. In reality, supermarkets compete by making different 'customer offers' that appeal to consumers in different ways.

Retailers make a customer offer – the '5 Ps of retail marketing' – to consumers to drive store choice. The standard Ps are **product** (range), **price** (regular and specials), **place** (location), **process** (ease of shopping) and **people** (service). The customer offer can also be described as market positioning or retail positioning.

Different customer offers act to serve the needs of both different consumers and different shopping occasions. For example, one supermarket may have lower prices; another has a more convenient location; and a third has higher quality fruit and vegetables.

Retail experts McMillan Doolittle argue that successful retailers dominate a position in the market which focuses on one or more of the Ps in some way.[9] In the New Zealand market, Pak'n Save could be an example of a supermarket primarily positioned against price.

It is important to recognise that consumers are not homogeneous; different consumers have different key drivers for store choice. For example, a single, retired person has very different needs and spending patterns to a single parent with three kids. In our CBA, we consider 45 different household types and income quintiles to account for some of these differences.

In addition, consumers have different types of shopping occasions/trips with different priorities. So, price isn't everything and there is no 'one-size-fits-all' supermarket solution perfect for everyone.

What is the competitive situation in New Zealand?

Supermarkets (and grocery stores) are the single largest sector of the New Zealand retail landscape accounting for NZ$23.3b in revenue.

Supermarkets and grocery stores have seen constant revenue growth. Over the past twenty-five years (1997-2022), New Zealand supermarket sales have grown at an average compound annual growth rate (CAGR) of 4.9% in non-inflation-adjusted terms and 2.5% per annum (CAGR) in inflation adjusted terms.

Supermarket spending is stable through time. Most of the growth in nominal supermarket spending can be explained as a function of three key drivers: population growth, per capita supermarket expenditure, and inflation.

[9] p.11 of https://www.amazon.com/Winning-At-Retail-Developing-Sustained-ebook/dp/B008NC0UNO/

New Zealand has a large supermarket industry that has consolidated into a duopoly of two remaining groups

New Zealand has two main groups – Foodstuffs and Woolworths – that currently effectively create a duopoly structure. Foodstuffs is a wholesaler that is co-operatively owned by the stores it supplies. No store owner can own more than one store. Woolworths NZ is a subsidiary of the Woolworths Group of Australia.

Both groups have different formats that make different customer offers

New Zealand has a total of 690 chain supermarkets and grocery stores spread across all regions of the country and operating under six different banners/fascia.

Foodstuffs

Foodstuffs operates 58 Pak'n Saves (a ‘super warehouse’ or ‘cut case warehouse’ store), 147 New Worlds (a traditional supermarket) and 226 Four Squares (small traditional supermarkets and large grocery stores).

Woolworths

Woolworths NZ operates 187 Countdowns (a traditional supermarket) and has two ‘captive banners’ that it franchises to store owners under the Supervalue/Fresh Choice fascia (both small traditional supermarket formats, totalling 72 stores).

It is important to note that New Zealand supermarket brands are not all the same; they vary dramatically in average revenue per store and other characteristics. Pak'n Save, in particular, has a much higher average revenue per store, which – based on the available market share data – we estimate is around 3 times as high as the average Countdown and four times as high as the average New World.

With the above as context, we now turn to the five key questions.

1. To what extent would retail divestment in the New Zealand grocery sector improve competition?

1.1. Our definition of competition

In this project, we are interested in how divestment might support 'workable competition'. Monash University describes workable competition as:

> *"An economic model of a market in which competition is less than perfect, but adequate enough to give buyers genuine alternatives."* [10]

Key elements of workable competition can be drawn from New Zealand case law:

> *"A workably competitive market is one that provides outcomes that are reasonably close to those found in strongly competitive markets… The degree of rivalry is critical. In a workably competitive market no firm has significant market power and consequently prices are not too much or for too long significantly above costs."* [11]

Further, the Commerce Commission adds:

> *"[l]n a competitive market, firms are incentivised to innovate, and entry to the marketplace may be facilitated. A competitive market usually provides customers, whether intermediate firms and/or end consumers, with increased choice".* [12]

1.2. What will happen if divestment does not occur?

The recently-announced measures[13] following the Commerce Commission's market study are likely to have some *modest* positive impacts on workable competition in the New Zealand grocery sector:

- They should allow smaller retailers better access to wholesale markets, at lower cost, allowing them to expand their market share.[14]

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[10] https://www.monash.edu/business/marketing/marketing-dictionary/w/workable-competition

[11] Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289 (11 December 2013), para 14-15, and 18

[12] Commerce Commission (2020, para 16)

[13] Namely regulating Woolworths and Foodstuffs to offer wholesale groceries to their competitors on "fair" and "good faith" terms, should they not do so voluntarily by the end of 2022; banning restrictive covenants on land and exclusive covenants on leases; establishing an industry regulator (the Grocery Commissioner); introducing a mandatory Grocery Code of Conduct; compulsory unit pricing on groceries; and more transparent loyalty schemes.

[14] To reflect this impact, in our CBA No divestment scenario the collective market share of smaller retailers (including specialist supermarkets, CostCo, convenience stores such as Circle K, online providers such as Supie, etc.) doubles from around 5% now to 10% over the next 20 years.

- The prospect of further regulation, related to wholesale pricing, divestment, or (say) facilitated entry, is likely to incentivise the major groups to act in better faith.
- It will be slightly easier for new stores to find suitable land.
- Consumers should be better informed around pricing and loyalty schemes.

We also acknowledge that over a twenty-year period, innovation, technological change and shifts in consumer preferences will also occur. These are difficult to predict with any certainty, however.

In our view, the recently-announced measures and incremental innovation alone are unlikely to see a *material* change in workable competition. They are useful moves to promote competition at the margin, but the duopoly structure will be hard to shift.

The lack of competitive threat of entry to challenge the existing duopoly structure of the supermarket sector is also unlikely to be materially affected by the government's response to the market study to date. Without significant changes to this threat of entry, there is little incentive for the major groups to substantially change their offerings.

Based on the last twenty years, and barring any significant change in regulatory settings or policy direction, we suggest the next twenty years in the New Zealand supermarket industry will look fairly similar to the last twenty (summarised in Table 4 overleaf).

TABLE 4 WHAT COULD HAPPEN OVER THE NEXT TWENTY YEARS?

What's happened over the past twenty years?	What might happen in the next twenty years?
New Zealand has the most consolidated chain supermarket sector in the developed world. In this New Zealand is an outlier distant from the mean of any peer group of countries.	This consolidated sector structure is unlikely to materially change. New Zealand will remain an outlier relative to its peer group.
There has been no significant shift in market share between the two groups in the last twenty years.	Barring the unexpected entry of a major overseas player, significant changes in the major groups' market shares seem unlikely.
There has been a reduction in the number of store fascia/brands in the market.	There could be further reduction in the number of store fascia/brands. For example, Supervalue could merge into Fresh Choice (Fresh Choice was originally called Supervalue Plus); Four Square could become New World Express.
Existing two groups have not introduced any of the key alternative formats developed since 1967 that have demonstrated ability to offer lower prices through having lower cost structures. Existing two groups have either purchased (e.g. Raeward Fresh), attempted to purchase (e.g. The Warehouse) or "run-out-of-town (e.g. Cost-U-Less) many emerging alternative formats.	Existing two groups may not introduce any of these key alternative formats and may seek to purchase or attempt to purchase any emerging competitor that is a threat.
New entrants into mainstream, mid-market, full-shop grocery retailing have failed (e.g. Warehouse Extra).	New entrants into mainstream, mid-market, full-shop grocery retailing could also fail.
New Zealand has the highest share of products sold on promotion in supermarkets for any country for which we have data. New Zealand supermarket retailers compete using a Hi-Lo pricing model (rather than an EDLP model).	These trends are likely to continue.
Low-cost areas will have higher prices and high-cost areas will have lower prices than in a typical competitive supermarket market.	These regional disparities in prices are likely to continue.

What's happened over the past twenty years?	What might happen in the next twenty years?
Range offered in mature, low growth product categories has been reduced, often down to one retailer brand or that and a single brand.	Ranges for these mature, low growth product categories may continue to be reduced.
Private labels (own brand or store brands) have increased as a percent of total supermarket sales.	This trend might be expected to continue.
More Australian products have been introduced to the New Zealand market. The range offered in supermarkets has become more similar across Australia and New Zealand.	Trans-Tasman consolidation of product lines could be expected to continue.
Supermarket gross margins have increased Supermarkets take a larger share of the customer's dollar than they did twenty years ago.	Supermarket gross margins could continue to increase, accounting for a greater share of consumer spending than they do today.
The cost of doing business – what it costs to run the business – has been increasing as a percent of the customer's dollar. This is not happening to the same extent at global retailers in highly competitive markets.	The cost of doing business could continue increasing as a percent of the customer's dollar.
New builds and remodels have becoming more expensive (even after adjusting for inflation). The cost/standard of fixtures and fit-out have increased.	Costs of new builds and remodels, plus fixtures and fit-outs may become increasingly costly.
Retail groups have invested in non-core elements of the business (e.g. high quality new offices).	Retail groups may continue to invest in non-core elements of the business.
Warehouse and distribution hubs have been consolidated down to the minimum on both islands.	It is not obvious that any significant further consolidation is possible.
Skilled labour has been removed from supermarkets (e.g. replacing butchers with case-ready meat).	Skilled labour could continue to be removed from supermarkets.

Source: Coriolis

1.3. What will happen to the major supermarket groups if divestment[15] occurs?

1.3.1. Supermarket groups could more actively control cost through increased efficiency and more careful spending

Woolworths New Zealand provides an example of what has happened over the last twenty years. Woolworths NZ has grown gross margins (as a percent of sales) since it acquired Progressive in FY2006 [EXHIBIT 1].

Over the same period, Woolworths is also spending more on running the business [EXHIBIT 2].

Similar to Woolworths, over the past two decades Foodstuffs appears – from the available public information – to have increased both gross margins and expenses [EXHIBIT 3].

This will have happened at both groups for a range of reasons, but a lack of workable competition, including the missing threat of entry from a significant player, is one factor.

Growing gross margins as a percent of sales is not some universal law of retailing; this effect is not happening for highly competitive global retailers. Successful, profitable, growing retailers in highly competitive markets control costs religiously [EXHIBIT 4].

We could expect cost control to become more of a priority under divestment scenarios.

1.3.2. Supermarket groups could reduce profits to reduce prices to maintain market share

Progressive Enterprises, through its various owners, provides a clear example. The profits (EBIT) at Progressive went up, stayed up and have increased since Progressive and Dairy Farm's Woolworths merged in FY2002 [EXHIBIT 5].

1.4. How else might the sector change if divestment does occur?

Divestment could also deliver three other main changes to the supermarket sector that may benefit consumers and suppliers.

1.4.1. Competing chains/banners could have a wider range of price positions and price strategies between them

The more food retailers that are present in a market, the larger the spread of prices that are observed between them [EXHIBIT 6]. This can be considered a 'law of retailing' as the pattern is clear across all developed markets in North America and Europe.

[15] This section relates to divestment as a generic concept. It is not directly linked to the specific divestment options considered in the cost-benefit analysis.

1.4.2. Consumers could have more, different supermarket customer offers to choose from

Price isn't everything; the stores with the lowest prices often (but not always) have poorer quality on fruit, vegetables, meat and other perishables; and the overall shopping experience may not be as good as stores with higher prices. If divestment were to give consumers more store choices in their local area, consumers could be more likely to find a specific store that meets their specific needs.[16]

New Zealand used to have more chains and so more variance between them in terms of price and other elements of the customer offer [EXHIBIT 7]. New Zealand has gone from having more choices when shopping for weekly groceries to having less; the market has become more homogenous [EXHIBIT 8]. This pattern is not observed in markets with more workable competition.

1.4.3. Food manufacturers and other suppliers could no longer depend on just two large customers.

The current market structure in New Zealand makes it difficult for new food and beverage start-ups to succeed [EXHIBITS 9 & 10]. The two major groups have significant buyer power and ability to influence the terms of supply. Significant supplier investments are required to scale up to meet demand from the two major groups and expansion can be very 'lumpy', depending on the timing of purchasing decisions from the two major groups.

The potential impact of divestment on net supplier prices is discussed in the CBA section later in the document.

1.5. Summary of response to Question 1

Without divestment or the threat of major new entrants, the current duopoly-dominated structure of the New Zealand grocery sector is unlikely to change for the foreseeable future. While there may be changes at the margin, such as the arrival of Costco and growth in online offerings, and some modest improvements for smaller retailers stemming from the government's response to the Commerce Commission's market study, significant structural change seems improbable.

At a high level, and depending on the nature of the regulatory intervention involved, divestment can be expected to lead to an improvement in workable competition in the New Zealand grocery sector. Provided the new stores remain viable, consumers will have more choice of banners and types of offerings (across price and non-price features) in areas where divestment occurs. Suppliers will have more buyers competing for their products, which should improve their bargaining power and returns.

[16] Note that the divestment options we analyse in the CBA will not lead to a wider range of stores in all local markets, just those with three or more supermarkets at present. Rural regions and/or small towns will be largely unaffected. As such, the benefits from divestment will not be equally shared.

2. What are the critical success factors in achieving grocery sector divestment in New Zealand and how would we know that divestment had been successful?

The critical success factors and the measures of success described below become the measures used in the criteria-based analysis in the next section of the report.

2.1. What criteria or measures were identified?

The project steering group defined five criteria or measures that act as both the critical success factors and the measures of success to measure workable competition:

1. More competitive market structure throughout New Zealand to the extent possible (e.g. by increasing the number of separate players in any local market/catchment area where possible).
2. Any rearranged existing players and/or any NewCo(s) having sufficient scale and integration to ensure enduring and effective competitiveness.
3. The extent to which any rearranged existing player/s and/or NewCo(s) might become more disruptive competitors (e.g. new formats, business models, etc).
4. Ensuring supply chain efficiencies (e.g. logistics and distribution costs, margins throughout supply chain, etc).
5. Regard for transition/adjustment costs and risks (implementation costs, timeliness, disruption of property rights, legal simplicity, equity of treatment, unintended consequences, etc).

2.2. Summary of response to Question 2

Effective divestment rests on several critical success factors related to the ease of implementation for government and firms.

The ultimate success of divestment actions can be defined in terms of delivering more enduring and efficient – and hence more workable – competition at the national and local areas (where possible). The success of divestment will also be judged by the clarity and equity of the regulatory process adopted.

3. What divestment options should the Government consider? Which is the preferred option and why?

Six options were identified for how divestment could occur:

- Four options (1-4) emerged from the Commerce Commission market study process and were outlined in the Request for Quotation.
- Two further options (5 and 5+) were proposed by the project steering group as our research developed.

We first define each option and outline how it might play out in practice. In section 3.7 we summarise the multi-criteria analysis used to score and rank the options.

3.1. Option 1 – Government-led divestment

3.1.1. How was it defined?

Option 1 was defined as follows:

> *"Government-led forced divestment by the three major grocery retailers to achieve 'like for like' competition. This would involve a national new entrant with minimum scale (estimated at 15-30% market share with a presence in the nine major urban centres).*
>
> *In particular, divestment would be required where there are particular pockets or areas within say, a radius of 5-8 kilometres where competition between stores is minimal or non-existent. This would involve the use of a measure of market share (e.g. the Herfindahl-Hirschman Index) to identify these areas, with a remedy that effectively 'unbundles' the ownership of some stores in these areas to promote greater competition."*

3.1.2. What could happen?

Conceptually, Option 1 involves using a set of criteria to identify a set of stores from both major groups to be divested into a NewCo. A Government-led divestment could create a large third player in the market of equal size to the two existing groups.

In Option 1, government could identify a set of specific actions that could deliver a new firm at scale nationwide [EXHIBITS 11 & 12]. Three different processes for splitting the stores emerged:

1. Retailers splitting their stores into three groups and the buyer choosing.
2. Government analysing the situation and engineering a split.
3. Retailers proposing and government approving.

Splitting the stores into three groups and the buyer choosing was identified as likely the easiest option to implement [EXHIBIT 13].

Therefore under Option 1 the two groups could be forced to divest 1/3 of their stores each into NewCo [EXHIBIT 14].

One potential configuration was developed [EXHIBIT 15], which assumes the NewCo's target 33% share comes from all incumbents proportionally.

NewCo could receive [EXHIBITS 16 & 17]:

- Stores from both groups
- Across every different retail banner and format
- Spread across New Zealand.

As a result, NewCo could immediately be a nationwide competitor at scale.

3.1.3. What are the challenges?

Implementation of Option 1 could face a wide range of problems.

First, a clear challenge under Option 1 is the difficulty in 'controlling' the numerous Foodstuffs owner-operators [EXHIBIT 18].

Independently owned and operated Foodstuffs stores that were going to be sold by the government could respond by leaving Foodstuffs and forming a new cooperative, benefitting from the Commerce Commission's requirement that supermarket wholesale arms sell to independent buyers/retailers on non-discriminatory terms [EXHIBIT 19].

Were this to happen, NewCo could be left with a much smaller group of stores (i.e. only the Woolworths stores, being about 1/6th of the market).

Second, in a normal retail acquisition, the buyer either gets an existing, complete and functioning group and/or already has stores in the area [EXHIBIT 20]. Option 1 creates a somewhat unprecedented situation (in supermarket retailing at least), where the buyer gets a patchwork of stores and systems [EXHIBIT 21].

Any buyer of NewCo could, in relatively short order, need to:

- Build a new management team and head office
- Secure and install common IT and management systems
- Develop a marketing campaign to sell NewCo to consumers
- Refresh all store exteriors and put-up new signage, refresh all store interiors, change ranging to a common standard, etc.

Obviously, these could need to occur in any acquisition. What is unprecedented is the need for all new everything, everywhere, all at once to be applied to a 'pick-and-mix' of stores of different sizes, shapes, layouts, and brands.

Third, any potential buyer could need to execute flawlessly on five major tasks, all highly challenging to get right: [EXHIBIT 22]

1. Hire a world-class team that can deliver this complex package of tasks successfully.
2. Install a full suite of IT systems (ordering, inventory, checkouts, accounting, website, etc.).
3. Build-out a logistics and warehousing system.
4. Transition a highly diverse group of stores spread out across the country to a new brand/fascia and refresh layout/ranging.
5. Market NewCo brand to consumers; begin the process of building brand loyalty.

Fourth, the sale process is not the end for any buyer. In addition to a purchase price that could be in the range of NZ$3-4b, any potential buyer of Option 1 NewCo could have three major costs beyond the purchase price:

(i) New warehousing (NZ$0.4-0.6b)

(ii) New management and non-store team (NZ$50-60m/year)

(iii) Implementation costs (unclear/unknown).

3.1.4. Summary of Option 1

This government-led divestment option could create a third major competitor at scale by forcing each major group to divest 1/3 of their stores to NewCo.

But the NewCo could receive a diverse range of stores under various banners. It could then face costly and time-consuming challenges re-branding and managing this patchwork collection of assets. There is also a risk of Foodstuffs' owner-operators leaving the parent cooperative and setting up their own cooperative instead of being forced to divest to NewCo.

3.2. Option 2 – industry-led divestment

3.2.1. How was it defined?

Option 2 was defined as follows:

> *"Company-led divestment by all three major grocery retailers to meet Government mandated market share caps - Requiring retailers to reduce and maintain their market share to below a cap (of 25% for example). Retailers would need to produce a plan for divestment based on set criteria (to avoid cherry picking for example) for approval by the regulator. On approval, this would represent an undertaking that would need to be implemented by retailers according to a set timeframe."*

3.2.2. What could happen?

Conceptually, Option 2 involves Foodstuffs and Woolworths NZ both splitting into two separate organisations, with additional stores moving out of pockets of concentration [EXHIBITS 23 & 24].

By causing this to happen, Option 2 could create a market of four separate, competing supermarket groups, all at minimum scale.

Where Option 1 is government-led, Option 2 is by design left to the two major retail groups to organise much, if not most, of their own solutions.

In Option 2, the government sets a target of an overall maximum market share that any New Zealand supermarket retailer can have by a specific date and – at the same time – a list of regions of excess concentration by one or other of the two groups that need to be addressed.

Each major supermarket group could then need to develop clear responses and proposals to government on how they could propose to meet these requirements.

A clear benefit of this approach is that it avoids any direct government expropriation of private property from any existing owner, either the owner-operators at Foodstuffs or the 350,000 shareholders of Woolworths (depending on what is assumed about who may or may not own the Woolworths' spin-off).

In Option 2, a clear set of rules (including specifically a national market share target) could be developed to deliver a four-player outcome. The retail groups could then develop their responses.

Option 2 seeks to find the most elegant point to set the national market share target to break up the two groups with the least disruption [EXHIBIT 25]. A range of targets were evaluated, and a 27.5% target emerged [EXHIBIT 26] as the point at which Foodstuffs could be incentivised to split by brand and Woolworth could have a range of viable options available to it.[17]

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[17] An alternative approach would be to require both groups to create a spin-off, with the new organisation having instead a minimum market share (e.g. 20%). Option 5+ develops a variant of this approach.

An industry-led divestment with a 27.5% target market share could change New Zealand into a market with four chains competing [EXHIBIT 27].

How could a 27.5% target potentially play out for Foodstuffs?

Operational efficiencies could make it highly likely that Foodstuffs could reorganise itself from regionally focused Foodstuffs North Island and Foodstuffs South Island into Pak'n Save Cooperative and New World Cooperative [EXHIBIT 28].

As a cooperative owned by its store owners, Foodstuffs could be incentivised to deliver successfully on this option. A successful execution of the required demerger could be in the interest of most Foodstuffs owner-operator shareholders.

While there could clearly be costs associated with the required reorganisation, there are currently two Foodstuffs organisations, with two management teams and two IT systems in place. Under Option 2, these systems and management teams could need to change.

Therefore, Option 2 could be more like an extensive restructuring than the significant divestment envisaged under Option 1.

How could a 27.5% target potentially play out for Woolworths Group?

Woolworths could have multiple options for getting its share down, with the company able to put forward a proposal for what was divested [EXHIBIT 29].

Basically, Woolworths could divest stores into NewCo [EXHIBIT 30]. NewCo could also receive a small number of Foodstuffs stores from pockets of concentration.

Woolworths has recently gone through a similar process in Australia with their liquor business which occurred smoothly in about three years.

3.2.3. What are the challenges?

To work smoothly, Option 2 could need some level of support from the existing retailers.

Option 2 needs to find the right balance between:

- not disrupting existing store banners too much and thus losing efficiency; and
- addressing local concentration.

The suggested solution is to put the burden on the supermarket groups to propose solutions that achieve the national market share target and address high concentration catchments.

Conceptually, Option 1 and Option 2 could seem to both potentially deliver a diverse package of stores [EXHIBIT 31]. The key difference is that in Option 2, most of the NewCo business is on a single system (Woolworths/Countdown) [EXHIBIT 32].

In addition, under Option 2 Woolworths could be incentivised to provide its NewCo with access to its IT and management systems (at least for a period of time, as it did with its Endeavour divestment in Australia).

Foodstuffs could need to rebrand a manageable number of stores between existing banners. Woolworths' spun-off NewCo could need to rebrand most or all divested stores. To do so, Woolworths NewCo could have three major options for re-branding the spun-off stores [EXHIBIT 33]:

(i) Using Supervalue or Fresh Choice

(ii) Reviving an old New Zealand brand (e.g. Foodtown)

(iii) Developing a new brand.

Under Option 2, NewCo could face a range of costs, particularly as the links to Woolworths were reduced and then finally cut. These could include new nationwide warehousing, new management and team, and implementation costs.

However, under Option 2, the spun-off NewCo *could* be well positioned to deliver on the five major tasks required for success [EXHIBIT 34].

3.2.4. Summary of Option 2

Option 2 could deliver four major competitors if the national market share cap was set at a level that incentivised Foodstuffs to split along banner lines and Woolworths to divest stores accounting for around 15% of its current market share to NewCo.

Adding local market concentration rules to the national market cap could increase complexity but is likely to be better aligned with government's objectives.

Since this divestment option is industry-led (albeit based on government rules and subject to government approval), a key benefit is that the interests of Foodstuffs' owner-operators and Woolworths' shareholders could best be served by delivering a successful outcome.

From a commercial perspective, there could be a range of costs involved, especially for Woolworths' spun-off NewCo, which could need to rebrand most of its stores and ensure cohesive IT and management systems were in place.

3.3. Option 3 – targeted divestment of brands

3.3.1. How was it defined?

Option 3 was defined as follows:

> *"Targeted divestment of brands - The divestment by retailers of one or other of their retail banners. For example, Foodstuffs could be required to divest Four Square branded stores."*

3.3.2. What to divest?

Option 3 sounds easy: two groups own all the brands, government could make them sell one (or more) of these brands to make a new competitor [EXHIBIT 35].

However, in practice there are fundamental issues with forcing the divestment of any one brand in New Zealand. The key challenge is the 'pieces on the board' are different sizes [EXHIBITS 36 & 37].

Most potential combinations of brands to be divested – with one from each group – are not fair to both groups or are not a viable competitor (or both) [EXHIBIT 38].

Only one combination of brands emerged as a possibility for divestment from all the various possible permutations: a package of Four Squares, some New Worlds, Supervalues and Fresh Choices [EXHIBIT 39].

3.3.3. What could happen?

Under Option 3 the government could develop a detailed set of market rules designed to deliver a NewCo from a combination of all the small supermarket and grocery store banners in New Zealand, being Supervalue and Fresh Choice from Woolworths and Four Square from Foodstuffs [EXHIBITS 40 & 41].

Foodstuffs could also need to divest some additional New World stores to balance up the divestment relative to Woolworths.

As a result, NewCo could have about ~14% national market share [EXHIBIT 42] and receive 316 stores spread across four banners and all regions of New Zealand [EXHIBIT 43], from Houhora in the far North to Stewart Island in the distant South [EXHIBIT 44].

3.3.4. What are the challenges?

Option 3 faces a wide range of challenges.

First, as with Option 1, there is a clear challenge under Option 3 in 'controlling' the numerous Foodstuffs owner-operators (and the various Supervalue and Fresh Choice franchisees) [EXHIBIT 18]. Rather than being divested to NewCo, they may instead set up their own cooperative [EXHIBIT 45].

Were this to happen, NewCo could be left with a much smaller group of stores or even no stores. Every single store that could be potentially divested under this option has an individual owner-operator.

Second, it is not immediately obvious what could be achieved by taking a small-town store from its owner and selling it to an investor or group of investors [EXHIBIT 46]. The hundreds of stores that could potentially be divested under this option are owned by hundreds of families, New Zealand citizens that live in towns up and down the country [EXHIBIT 47].

Most of these stores are under the threshold of what in retailing is known as 'effective chain store control' or the point at which the store is too small to afford to have an employee running it. In retailing, this is the point at which franchising makes sense. Therefore, any buyer of NewCo could end up replacing one owner-operator franchisee with another.

Alternatively, all of these hundreds of owner-operators could receive a pay-out for their store, walk away happy and leave hundreds of towns without anyone running the local store.

Third, any potential buyer could receive a diverse package of primarily small stores spread across multiple layouts and formats [EXHIBIT 48].

Fourth, these stores are primarily located in secondary sites and rural regions and spread out over a huge region [EXHIBIT 49]. Without the large base volumes moved through a region's main supermarket groups, this could be a logistical nightmare.

Fifth, any potential buyer could need to execute flawlessly on the five major tasks [EXHIBIT 50], all highly challenging to get right.

Sixth, and as in Option 1, the buyer will face a range of significant costs beyond the purchase process. In addition to a price that could be in the range of NZ$1-1.5b, any potential buyer of Option 3 NewCo could need to spend significant sums on new warehousing (NZ$0.4-0.6b), a new management and non-store team (NZ$50-60m/year), and other implementation costs (cost unclear/unknown).

3.3.5. Summary of Option 3

While perhaps intuitively appealing at first glance, Option 3 could be very challenging to make work in practice. It could result in a NewCo receiving over 300 smaller stores spread across New Zealand, all of which are owner-operator franchises.

How these owner-operators could respond to a government decision designed to bring them all together under a new banner is highly uncertain, but the process is unlikely to be smooth. Many of them could walk away from the new arrangement, which could leave rural towns at risk of having no grocery stores.

The costs associated with implementing this option are likely to be very high, especially coordinating logistics across so many small and remote stores.

3.4. Option 4 – wholesale ownership separation

How was it defined?

Option 4 was defined as follows:

> *"Splitting the ownership of wholesale and retail ownership to ensure new market entrants are able to access wholesale groceries at the same prices as their competitors."*

3.4.1. What could happen?

Option 4 conceives of the supermarket duopoly as being similar to an electricity or telecommunications monopoly needing separation. This option was described by one proponent as follows:

> *"Firstly, we believe access to independent wholesale supply will deliver positive outcomes for new entrants and expansion of existing retailers. This could be done through structural separation, divestment, or funding of a whole new wholesale business. The options would need to be assessed, and we have some ideas on how this can happen. But in principle, this has been done before in telecommunications with the likes of Chorus. And to reiterate, wholesale supply needs to be independent."*[18]

There are multiple ways to enable existing, emerging and potential non-duopoly retailers to access wholesale supply. We look at only one: divestment by both groups of their wholesaling activities. In other words, forcing both existing major retailers to divest their existing wholesale operations through a sale or spin-off.

In Option 4, both existing supermarket groups could be forced to divest their wholesaling activities and in parallel with this a new set of market regulations could need to be developed [EXHIBIT 51].

Conceptually, this could involve Foodstuffs North Island, Foodstuffs South Island and Woolworths NZ all divesting their wholesale activities into separately owned independent businesses (WholeCo's) [EXHIBITS 52 & 53].

Unlike the other options, Option 4 proposes that the key to competition is separating the ownership of wholesale and retail functions. Seven apparent hypotheses appear to underlie this proposal: [EXHIBIT 54]

1. The reason there is a duopoly is that innovative new entrants cannot enter the middle-New Zealand, 'main order foodstuffs' market.
2. New entrants that have taken on the duopoly directly have failed (e.g. Warehouse Extra, Cost-U-Less).

[18] Sarah Balle, Day 7, Retail Grocery Market Study Conference, 2 November 2021

3. Surviving competitors currently focus on niche segments. (e.g. Huckleberry, Tai Ping, Wang, Farro).
4. Small chains have struggled to scale past around 8 stores.
5. There are no longer any independent, full-line grocery wholesalers left in New Zealand.
6. If New Zealand had an independent full-line grocery wholesaler at scale, small chains could grow to become viable competitors.
7. Even under the new post-market study regulations, the duopoly will not wholesale on fair terms.

The core argument for taking the significant step of pulling apart an integrated, functioning food delivery system [EXHIBIT 55] is the belief that the newly independent wholesaler could wholesale to existing, emerging and potential non-duopoly retailers on fair, reasonable and competitive terms [EXHIBIT 56].

3.4.2. What are the challenges?

On the face of it, wholesale separation sounds like a good idea as it has been used successfully in other industries to increase consumer choice [EXHIBIT 57]. However, upon deeper analysis, it becomes clear that Option 4 is fundamentally flawed.

The two retail groups could need to be forced to buy from their wholesaler [EXHIBIT 58]. If this were not the case, the retailer could just treat the loss of ~$600m in warehousing assets as a very large fine and build new infrastructure. Once this new infrastructure came online, the formerly associated WholeCo could go into receivership with the loss of its largest customer.

If government instead mandated the use of WholeCo by the retailer, it could inexorably be drawn deeper and deeper into the minute details of the procurement, pricing and distribution of tens of thousands of individual grocery items.

The outcome could be an unusual and unstable market structure, with government being required to play a major role in an area of considerable complexity and unfamiliarity.

Globally, there are two broad models for grocery wholesaling: [EXHIBIT 59]

1. Independent ownership.
2. Integrated ownership by either a chain-store operator or a co-operative of store owners.

The independent model has basically failed across the developed world, including New Zealand. Independent wholesalers used to control a large part of the New Zealand grocery industry [EXHIBIT 60] and have all disappeared [EXHIBIT 61]. It is not obvious why an independent wholesaler could succeed under this option when they have previously failed.

Numerous examples exist globally of both working models for integrated supermarket wholesaling [EXHIBIT 62]. Indeed, both working models already exist in New Zealand.

There is also a lack of clarity about what problem this trying to solve and for whom. More specifically, we have seen no independently-evaluated evidence for the supposed significant market demand for independent full-line, mid-market grocery wholesaling [EXHIBIT 63].

The case for Option 4 is almost solely predicated on it successfully enabling significant new entrants who will enter the market and take material amounts of market share such that the eventual gains to the consumer in the future will outweigh the huge disruptions this will cause to existing supermarket groups today.

We assess the benefits of independent wholesaling are being oversold [EXHIBIT 64]. In-and-of itself, independent wholesaling does not remove the five fundamental challenges for new chains attempting to enter supermarket retailing:

1. Building supermarkets is capital intensive.
2. New, start-up retailers hit the 'Death Zone' at about six stores, when costs start to grow faster than profits (as the firm needs a head office, etc.).
3. Differentiated retailers run out of areas with concentrations of their target demographics.
4. Premium grocery retailers struggle to scale.
5. A global peer group shows new grocery retailing start-ups have a very poor record.

3.4.3. Summary of Option 4

On the face of it, wholesale separation might sound like a good idea as it has been used successfully in other industries to increase consumer choice.

However, independent wholesaling is no longer seen in the supermarket industry in developed countries. And New Zealand's previous independent retailers have also disappeared.

Forced divestment of the major groups' wholesale arms could cause significant disruption to the existing vertically integrated grocery market structure and could impose significant costs on retailers. These costs could ultimately be borne by consumers.

The regulatory requirements of trying to make wholesale separation work could be considerable, and considerably complex.

3.5. Option 5 – Industry-led, with local market focus: three main players

Option 5 and 5+ emerged part way through the process from the project steering group, in response to various limitations highlighted in our initial evaluation of Options 1-4.

3.5.1. How was it defined?

Option 5 was defined by the project steering group as follows:

> *A specific formula will be applied to ensure sufficient stores are divested so as to achieve more competitive market structures both:*
>
> *(a) in all local market areas to the extent that this is practically achievable; and*
>
> *(b) at a national level by ensuring a third player is able to achieve sufficient national scale (for example, around 20%).*

3.5.2. What could happen?

Option 5 could use a set of rules to create a market of three separate, competing supermarket groups, all at scale. While the high-level outcome (a market of three competing groups with no group holding greater than, say, a 40% national market share) is clear, the fine detail could be dependent on specific, detailed decisions made by the two groups in local markets.

The divestment process under Option 5 could be industry-led in response to government setting local and national market cap rules, and the major groups' proposals could need to be submitted to government for approval.

3.5.3. How could it work in practice?

Option 5 has a clear process for determining where divestiture will occur [EXHIBIT 65]. Option 5 is best understood as a process that happens by iteratively analysing each local market area in New Zealand and identifies where divestment needs to occur based on a formula that varies by the number of supermarkets in the area.

First, one- and two-store towns remain untouched. As three-quarters of local market areas are one and two store towns, most local areas will remain untouched [EXHIBIT 66].

In total, 164 local market areas have one or two stores and are therefore excluded from mandatory divestment [EXHIBIT 67]. In New Zealand, Foodstuffs has significantly more stores in one and two store towns, particularly Four Square stores [EXHIBIT 68].

Next, three-store towns trigger a specific divestment rule: The group with 2 or more stores must divest down to 1 store.

Around 8% of local areas or catchments – or 18 catchments – have three stores and therefore trigger this three-store rule [EXHIBIT 69].

Finally, a 'market share rule' is applied to the remaining ~18% of local markets or catchments – 39 catchments containing 428 supermarkets – that have four or more stores [EXHIBIT 70]. In these markets, market share is used to determine what divestment must take place: a group(s) with more than 40% local market share nominates store(s) to divest until they reach 40%. Nominated stores go to another existing group or into a new entity with at least 20% national market share.

Option 5 gives significant discretion to the retail groups about what stores they divest. Therefore, no definitive outcome can be determined for this option.

Instead, for each of the catchments with three or more stores, we analysed likely actions of a 'rational supermarket retailer' to determine what could potentially be divested. Our analysis uses this conceptual rational supermarket retailer to present a *potential* strawman for the outcome of Option 5 [EXHIBIT 71].

At a high level, this could potentially see:

- Foodstuffs divesting most Pak'n Saves into a 'Pak'n Save Co-Op'.
- Foodstuffs divesting most New Worlds and Four Squares into a 'New World Co-Op'.
- Woolworths divesting 16 Countdowns, 11 FreshChoices and 15 Supervalues into these new Foodstuffs co-operatives, but keeps the bulk of its Countdowns and other banners.

The key benefits of this option could be that:

- As with Option 2, it is industry-led (subject to government rules and approval), which incentivises participants in the divestment process to deliver viable new entities that could benefit their owners/shareholders.
- It could likely have lower implementation risks than some of the other options discussed above, as no NewCo is created. The process could begin with three groups (FS North Island, FS South Island and Woolworths NZ) and end with the same three groups, albeit with the two Foodstuffs groups likely rebranded and reorganised.
- It could create three retail competitors of a similar size.

3.5.4. What are the challenges?

Under the currently-proposed Option 5, there will be no changes in ownership in any local area with less than three stores, and hence no improvement in local workable competition. These stores, often in rural or small towns, will however potentially face higher costs (e.g. supplier costs) associated with the outcome of the divestment on a nationwide basis.

Option 5 could likely have widely different impacts on the two major groups. This may raise questions regarding how equitable this option is.

Based on our initial analysis (which is just one potential configuration out of many):

- Foodstuffs collectively could end up with ~5% more market share after divestment than it currently holds [EXHIBIT 72]. It could need to undertake a comprehensive reorganisation to deliver on the requirements of this option.

- Woolworths, in contrast, could face smaller structural change (relative to Foodstuffs and relative to other options), but could experience a net loss of 40 stores.

We acknowledge that the actual outcome of this option will depend on the choices of the two major groups in response to the rules imposed on them.

In addition to the initial Foodstuffs reorganisation, we assume regulators could specify that at some point (e.g. within five years), Pak'nSave could need to invest in its own new warehousing separate from New World to avoid potential risks from horizontal coordination, and/or that Pak'n Save would want to do so in any case to ensure it develops its own fully vertically integrated supply chain.

This risks duplicating existing upstream infrastructure, adding inefficiencies to the grocery supply chain.

3.5.5. Summary of Option 5

Option 5 was developed by the project steering group to address some of the limitations of Options 1-4, particularly related to implementation challenges. It seeks to provide the major groups with discretion to organise their stores as they see fit, provided a national market share cap of 40% is met and local area competition is promoted.

This option would deliver improved competition in major centres but is unlikely to deliver benefits to consumers living in towns with only one or two stores.

Option 5 could likely result in Foodstuffs largely splitting along banner lines and facing a reorganisation of upstream and management functions. We assume that following a transition period, the separated entities will be prevented from sharing warehousing.

Woolworths could divest stores equivalent to around 5% of its national market share to these two Foodstuffs spin-offs. There may be concerns about how equitably this option treats the two major groups.

3.6. Option 5+ - Industry-led, with local market focus: four players

3.6.1. How was it defined?

Option 5+ was defined as follows:

> *A specific formula will be applied to ensure sufficient stores are divested so as to achieve more competitive market structures both:*
>
> *(a) in all local market areas to the extent that this is practically achievable; and*
>
> *(b) at a national level by ensuring two new players emerge and are able to achieve sufficient national scale (for example, around 15%; so both new players would have ~30% combined).*

3.6.2. What could happen?

Option 5+ could take a similar form to Option 5 but could seek to create a market of four (rather than three) separate, competing supermarket groups.

The two major groups could need to satisfy national and local market conditions in submitting their proposals to government for approval. No retailer may end up with a national market share of greater than 35% and the new entities should have around 15% market share at minimum.

As with Option 5, this option emerged part way through the process from the project steering group in response to the initial evaluation presented of Options 1-4.

3.6.3. How could it work in practice?

The Option 5+ formula takes the following shape: [EXHIBIT 73]

First, one- and two-store towns are unaffected by any mandatory divestment (as in Option 5) [EXHIBITS 74, 75 & 76].

Second, three- and four-store towns trigger a specific divestment rule: A group with 2 or more stores must divest down to 1 store.

Eighteen catchments have three stores and therefore trigger this 'three-store rule' [EXHIBIT 77]. Six catchments have four stores and therefore trigger the 'four-store rule' [EXHIBIT 78].

Third, a 'market share rule' is applied to the remaining ~15% of local markets or catchments (33 catchments containing 404 supermarkets) that have five or more stores [EXHIBIT 79].

In these markets, market share is used to determine what divestment must take place: A group(s) with more than 30% local market share nominates store(s) to divest until they reach 30%. Nominated stores go to another existing group or into a new entity with at least 15% national market share.

Using a similar 'rational supermarket retailer' approach as in our analysis of Option 5, catchment by catchment, one *potential* outcome is developed [EXHIBITS 80 & 81].

The outcome is similar to Option 5 for Foodstuffs in that most Pak'n Saves could be kept together in one new co-op, and most New Worlds and Four Squares could be kept together in another co-op.

Woolworths could keep most of its Countdown stores in one company, and NewCo could receive a mixture of Countdown, FreshChoice, New World, and Four Square stores.[19]

3.6.4. Option 5+ has similar strengths and weaknesses to Option 5

The main differences to Option 5 are that:

- The new entities could be relatively smaller competitors.
- A NewCo could be formed which could require new management, branding, IT systems, etc. This could be made more challenging due to the diverse range of store banners and sizes it receives through the divestment process.
- Relative to Option 5, Woolworths experiences a larger loss of stores, again raising concerns over how equitably the major groups are treated.
- Two additional sets of upstream facilities could need to be developed instead of one, raising the risk of duplication and supply chain inefficiencies relative to Option 5.

[19] Based on advice from the project steering group, we were asked to assume Woolworths would be prevented by regulation from owning this NewCo.

3.7. Which is the preferred option(s) and why?

A criteria-based scoring system was developed by the project steering group and applied to the six options. These criteria are discussed in detail in section 2 above.

Each criterion received equal weight. These criteria were then applied to all six options, with scoring being on a seven-point scale.

Final scoring emerged from Coriolis and the project steering group.

TABLE 5 CRITERIA BASED ANALYSIS

Criteria	Option 1	Option 2	Option 3	Option 4	Option 5	Option 5+
1. More competitive market structure throughout NZ to the extent possible (e.g. by increasing the number of separate players in any local market/catchment area where possible)	+2	+2	+1	+1	+2	+2
2. Any rearranged existing players and/or any NewCo(s) having sufficient scale/integration to ensure enduring and effective competitiveness	-1	+2	-2	-2	+2	+2
3. The extent to which any rearranged existing player/s and/or NewCo become more disruptive competitors (e.g. new formats, business models, etc)	+1	+1	-1	+1	+1	+1
4. Ensuring supply chain efficiencies (e.g. logistics and distribution costs, margins throughout supply chain, etc)	-1	-1	-1	-2	-1	-1
5. Regard for transition/adjustment costs and risks – (implementation costs, timeliness, disruption of property rights/legal simplicity, equity of treatment, unintended consequences, etc)	-2	+1	+1	-3	+1	+1
TOTAL	**-1**	**5**	**-2**	**-5**	**5**	**5**

Source: Coriolis analysis (Options 1-4); project steering group (Options 5-5+)

From this process, Option 5+, Option 2 and Option 5 emerged as the highest-scoring options.

Based on direction from the project steering group, Option 5 and Option 5+ were selected to proceed to the formal cost-benefit analysis stage.

3.8. Summary of response to Question 3

We explored four divestment options taken from the RfQ and two additional options designed by the project steering group using:

(i) A commercial assessment of how each option might work in practice, along with potential strengths and weaknesses.

(ii) A criteria-based analysis drawing on the critical success factors developed by the project steering group from section 2 that relate to the promotion of workable competition.

Based on these assessments, Option 2, Option 5 and Option 5+ were the highest scoring approaches to divestment.

Based on direction from the project steering group, Option 5 and Option 5+ were selected for quantitative analysis in the CBA.

4. What are the estimated quantified costs and benefits of the options in the short and longer term, and what are the distributional impacts of those costs and benefits?

See Sense Partners and Cognitus (2022) for the full report

4.1. CBA scope

Sense Partners, with the support of Cognitus, designed and implemented a **high-level, indicative and exploratory cost-benefit analysis** (CBA) of potential divestment options in the New Zealand grocery sector.

The CBA compares the costs and benefits of divestment Option 5 and Option 5+, designed and provided to us by the project steering group, against a No divestment scenario that incorporates recently-announced government measures to promote competition in the grocery sector in response to the Commerce Commission's market study.

4.2. Key limitations of CBA

Our CBA should be seen as **high-level, indicative and exploratory** only. It is not a forecast of what *will* happen in the supermarket sector over the next 20 years. Rather, it solely seeks to examine the potential costs and benefits of a given set of assumptions related to selected divestment options.

There is any number of potential scenarios that could play out in the supermarket sector over the next two decades. We do not attempt to explore them all. In line with the RfQ and guidance from officials, **we retain a tight focus on a narrow range of divestment options**. The two scenarios explored in the CBA were designed by the project steering group.

The CBA was **completed over an eight-week period**. This time constraint put hard limits on the number of scenarios we could explore and the degree of detail we could go into.

We **did not have access within the project timeframe to company data on store revenues, costs and profits at the local market level**. This is a material limitation. We strongly advise that further, more in-depth analysis be undertaken – using richer data and more sophisticated techniques – before any divestment strategy is committed to.

In lieu of detailed company data, the CBA was populated with a synthetic data set drawn from publicly available data sources and many assumptions. We have prepared sensitivity analysis to highlight the impacts of changing key assumptions.[20]

We **do not examine any legal matters related to divestment**. These were out of scope, as per the RfQ, which asked suppliers to focus on "the economic case for divestment, rather than any legislative issues or obstacles associated with a divestment remedy". Likely to prejudice international relations

4.3. Overview of approach

4.3.1. Methodology

We use a timeframe of 20 years for the CBA, recognising that any divestment options would take time to develop, legislate, announce, litigate, implement and finally transition to a new 'steady state'.

To be judged successful, a divestment option must satisfy two key criteria:

i. It must deliver long-term net benefits to consumers; and

ii. It must be net positive for society.

Both conditions require any NewCo to be commercially viable and durable. We do not explore viability in any detail in this CBA, however. See section 5 for an overview of the potential commercial risks for NewCo associated with divestment.

We first estimate changes in retail margins and producer surplus from divestment using a de-merger model. The model takes into account changes in variable costs from divestment, and we incorporate changes in fixed costs (such as re-branding) with out-of-model adjustments.

We run the model at the local market level (57 areas with three or more supermarkets) to capture different regional concentrations of supermarkets. The national level results are the sum of these local impacts.

[20] Our results contain much more uncertainty than they would if we had more detailed data. This is particularly so for the analysis of divestment impacts on consumers in specific smaller markets, and for our out-of-model assumptions on potential cost changes from divestment. Uncertainty about existing costs and margins, store by store and market by market, means that when we are considering potential changes in costs we are examining uncertain future effects on top of significant uncertainty about the baseline. And, as our sensitivity analysis shows, changes in assumptions about impacts on costs can swing results from net benefits to net costs. Those parts of the analysis that rely heavily on lessons from overseas research and conceptual models – such as the modelling of effects of changes in market concentration on supermarket prices – are less affected by data limitations. We expect the modelled findings would not change significantly enough, given additional data, to alter qualitative findings or broad orders of magnitude at the national level. But the distributional impacts across local areas and for certain household types could be materially different.

We then estimate changes in benefits to consumers using a household expenditure model that takes the price changes from the de-merger model and translates them into changes in consumer surplus.

We incorporate potential consumer gains from an increased variety of offerings in the supermarket sector following divestment as an out-of-model calculation.

The household expenditure model is estimated for nine different household types (varying the number of adults and number of children) and by income quintile. This gives us a total of 45 different household 'personas' and allows us to see how the divestment options affect (say) poorer households, single-parent households, etc.

Consumer impacts are also calculated at the local area level to illustrate the potential distributional and spatial effects of divestment options on a range of household types.

The net benefit to society of divestment options is the sum of the changes in consumer and producer surplus out to 2042, discounted at standard Treasury discount rates. We conduct sensitivity analysis around the discount rate and other key parameters.

4.3.2. Benefits and costs considered

Based on the consultants' experience analysing mergers and vertically integrated industries, we consider a range of potential costs and benefits in our analysis.

TABLE 6 TYPES OF COSTS AND BENEFITS INCLUDED IN CBA

Quantified benefits	Why included?
Benefits to consumers from lower retail margins	More competition drives down retail margins, which – all other things equal – leads to lower retail prices for groceries. However, these lower retail margins may be applied to a higher cost base following divestment.
Benefits to consumers from variety	A wider variety of stores in each affected local area gives shoppers more choices regarding supermarket offerings. These benefits may be mitigated if supermarkets choose to reduce the range of products they sell to contain costs, and retain bargaining power vis-à-vis suppliers, over a narrower range of product lines.
Benefits to producers from greater competitive efficiency	Greater competition pushes supermarkets to innovate harder and improve productivity.
Quantified costs	**Why included?**
'Double marginalisation' costs	If wholesale is separated from retail through divestment, wholesalers may seek to add a mark-up to their costs when selling to retailers without vertically integrated supply chains
Supplier price increases	After divestment, there are more potential buyers, each with lower market shares and less bargaining power than before. This allows at least some suppliers to increase their prices.
Higher industry overheads	Divestment may lead to a double-up in some group-level functions, such as headquarters' costs, HR, marketing and advertising.
Divestment one-off costs	Divestment leads to costs related to preparing assets for sale, such as legal costs, changes to contracts, changes to IT systems, etc.

Rebranding/fit-out one-off costs	As stores move between the major groups after divestment, they will need to be rebranded, have their layouts changed, etc.
Vertical integration one-off costs	After a transition/preparation period of five years, we assume spin-off entities set up their own warehousing/storage and logistics systems to become stand-alone vertically integrated businesses.
IT system costs; brand-building[21]	If divestment creates a NewCo that is not closely tied to its pre-divestment parent, it will need to lease IT software and equipment. It will also have to build a new brand.
Unquantified costs/risks	**Why discussed?**
Likely to prejudice international relations	
Implementation risks	Divestment might be subject to legal challenge, which might delay, change or possibly even ultimately defeat the intervention. Supermarket owners may be able to reorganise their current arrangements so as to evade or distort how divestment works. The complexities of successfully carrying out such a major intervention may prove to be unmanageable.

Source: Sense Partners and Cognitus

We develop Central, Low (overall more pessimistic) and High (overall more optimistic) scenarios for each option, recognising the uncertainty across many of these costs and benefits.

The Low and High scenarios are not intended to be worst-case or best-case outcomes, but instead represent variations around the Central case to provide a sense of the potential range of outcomes based on reasonable assumptions on key parameters.

Note that in these scenarios, some benefits are negative, and some costs fall, as we assume a range of potential outcomes.

[21] This is relevant for Option 5+ only in our CBA.

4.4. Scenarios

4.4.1. No divestment scenario

The No divestment scenario against which Option 5 and 5+ are compared incorporates the effects of recently-announced changes to the supermarket sector in New Zealand. The No divestment scenario also includes the entrance of Costco, which will become a small competitor in the market.

These changes combine to reduce the major groups' profit margins below what would otherwise be the case and increase those of other retailers. Note these impacts are assumed, rather than separately estimated (which was out of scope for this project).

We do not build the entry of other potentially significant, disruptive competitors such as Aldi or Lidl into the No divestment scenario, although we acknowledge this could occur in the future.

We do not explore other potential regulatory changes, technological developments or consumer preference shifts beyond divestment in the options analysis. This ensures the costs and benefits we compare against the No divestment scenario are only attributable to divestment, not other market or regulatory changes.

4.4.2. Option 5

See analysis above in section 3.5 for a description of Option 5 and Coriolis's assessment of how it might play out in practice.

In the CBA we characterise Option 5 at the national level as:

1. Splitting New Worlds and Four Squares from Pak'n Saves, leaving two Foodstuffs spin-offs:
    a. FS1: largely Pak'n Save stores (PnS).
    b. FS2: largely New World (NW) and Four Square stores (4S).
2. Woolworths divesting selected Countdown stores (CD) amounting to 5% of national share to FS2 and retaining most Supervalue (SV) and FreshChoice stores (FC).
3. This results in:
    a. FS1 (PnS) with ~33% national market share.
    b. FS2 owning NW, 4S and selected CDs, with ~30% share.
    c. Woolworths (CD/SV/FC) with ~37% share.

An essential point is that in this characterisation of Option 5 there would be three substantial (mostly) vertically integrated competing chains, with more competitors in key population centres.

4.4.3. Option 5+

See analysis above in section 3.6 for a description of Option 5+ and Coriolis's commercial assessment.

In the CBA, we draw on Coriolis's assessment and assume:

- Most Pak'n Save stores could be kept together in one new co-op (FS1)
- Most New World and Four Square stores could be kept together in another co-op (FS2).
- Woolworths would keep most of its Countdown stores in one company (WW1)
- NewCo would receive a mixture of Countdown, FreshChoice, New World, and Four Square stores (WW2).

4.4.4. Key assumptions related to divestment benefits and costs

In the timeframe available, and reflecting a lack of store-level data, we needed to make a series of assumptions related to some of the costs and benefits listed in Table 6.

These assumptions were based on a combination of insights from the international literature on mergers and de-mergers, substantially augmented with the professional judgement of the consulting team for this project.

We vary these assumptions across the Central, Low and High scenarios. See Appendix A for a summary of scenarios and assumptions for both options.

4.5. Summary of scenarios and results

4.5.1. Option 5 scenarios

TABLE 7 DESCRIPTION OF CENTRAL, LOW AND HIGH SCENARIOS FOR OPTION 5

Scenario	Key features
Central	Legislation is drafted and passed in 2023, and firms have the following two years to prepare for divestment. The residual WW chain remains fully vertically integrated after divestment. FS1 (PnS) narrows its range of products offered to contain its costs and increase its bargaining power with suppliers. FS2 (NW/4S+) and WW marginally improve their offerings to differentiate themselves from FS1 on variety (rather than go head-to-head on low-cost pricing). Consumers do not experience variety gains, as we assume the effects of smaller ranges for FS1 exactly offset the potential gains from consumers having more choice of stores and increased variety from WW and FS2. FS1 contracts for warehousing and related upstream services from FS2 at similar cost to the No divestment scenario (i.e. no mark-up applied under an 'amicable divorce') for five years (2026-2030). From 2031, FS1 is required by regulation to be separately vertically integrated (to preserve competition incentives), so invests in new warehousing in 2029 and 2030. Supply costs increase relative to the No divestment scenario as each buyer now has lower individual market share. FS1's supply price increases are moderated by it narrowing its product range, proving greater opportunities for volumetric discounts. Group overheads (marketing, head office costs) for WW are unchanged. For Foodstuffs, branch overheads are assumed to reduce in line with the number of stores in FS1 and FS2. The splitting of Foodstuffs does lead to an increase in industry overheads, however this is assumed to involve only modest duplication because FS1's business model (e.g. range reduction) has offsetting cost advantages and the FS2's group overheads scale down, from Foodstuffs No divestment scenario group overheads, reflecting reduced scope for group activities. For all banners, additional retail competition drives efficiency gains of 2% of No divestment scenario overheads. WW and FS2 spend $0.25m per store received for re-bannering and fit-out. FS1 spends $2.5m per CD and NW received to re-banner to PnS.
Low (overall more pessimistic)	Legislation is drafted and passed in 2023, and firms have the following three years to prepare for divestment (one more than in the Central scenario). The residual WW chain remains fully vertically integrated after divestment. As in Central, FS1 (PnS) narrows its range of products offered to contain its costs and increase its bargaining power with suppliers. FS2 and WW increase their range of offerings to competitively differentiate themselves from FS1 in non-price terms. FS1 contracts for warehousing and related upstream services from FS2 during a transition period of five years (2027-2031), <u>but</u> FS2 now applies a mark-up for these services. From 2032, FS1 is required by regulation to be separately vertically integrated, so invests in new warehousing in 2030 and 2031. These warehousing costs are 10% higher than assumed in the Central scenario.

Scenario	Key features
	Supply costs increase slightly relative to the Central scenario, assuming suppliers have slightly more bargaining power than assumed in the Central scenario. Creation of new supermarket groups leads to complete replication of group overhead expenses (marketing, management, centralised HR). For all banners, additional retail competition drives efficiency gains of 1% of overheads in the No divestment scenario. Consumers experience a small loss of variety, as we assume the effects of smaller ranges for FS1 more than offset the potential gains from some consumers having more choice of stores and FS2 and WW slightly broadening their offerings. WW and FS2 spend $0.5m per store received for re-bannering and fit-out. FS1 spends $3m per CD and NW received to re-banner to PnS.
High (overall more optimistic)	WW remains vertically integrated as in the Central scenario, and the adjustment following divestment is smoother (less costly). Operating expenditure falls relative to the Central scenario as it manages to shed more legacy overheads after divesting its stores. We assume operating expenditure falls by more than in the Central scenario for WW and FS1, and that FS2's cost increases are slightly lower. This is based on the premise that the post-divestment period proves to be less costly than in the Central scenario. Supplier prices do not change relative to the No divestment scenario. This reflects that there are three buyers in the No divestment scenario (WW, FS NI and FS SI) and under Option 5 there are still three buyers, albeit reorganised and more competitive. This scenario assumes no material shift in bargaining dynamics between suppliers and the major supermarket buyers beyond that in the No divestment scenario. Divestment preparation costs, vertical integration costs and rebranding/fit-out costs are all considerably lower than in the Central scenario (e.g. FS1's costs of new warehousing are 10% lower). Industry overheads are almost entirely unchanged. We assume consumers enjoy a small net increase in variety, with the additional choice of WW and FS2 offerings more than outweighing the loss in range from FS1. For all banners, additional competition drives larger efficiency gains of 3% of overheads in the No divestment scenario. WW and FS2 spend $0.1m per store received for re-bannering and fit-out. FS1 spends $2m per CD and NW received to re-banner to PnS.

Source: Consultants' assumptions

4.5.2. Option 5 results

Our Central case estimate of the effects of Option 5 is a present valued net benefit of $545 million (2022 dollars).

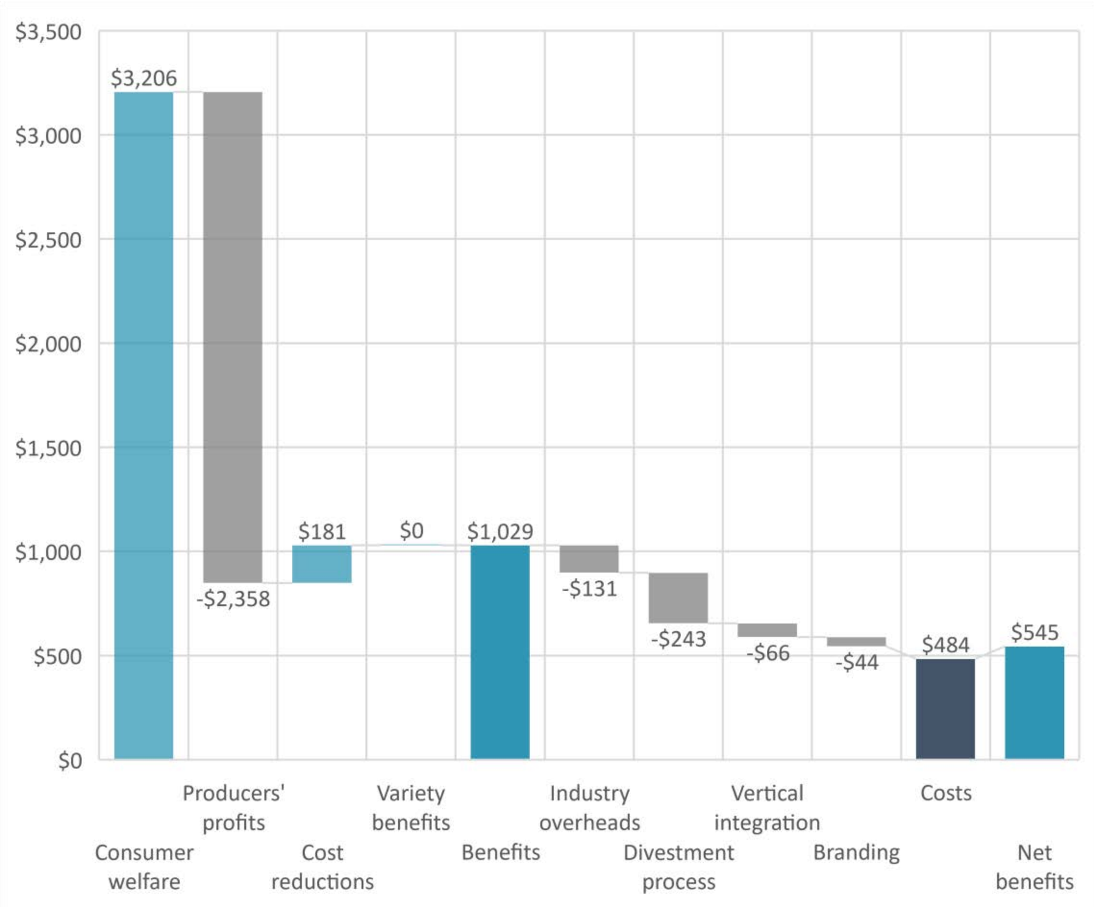
By far the biggest driver of this result is the net gain in allocative efficiency from lower prices through greater competition and lower supermarket margins. This is the net of large estimated gains to consumers (the first column in Figure 1) from lower prices less costs to producers from reduced profits (the second column in Figure 1).

This estimated benefit equals $848 million and represents the economic value of expanded supermarket trade or, equivalently, a reduction in deadweight loss from high prices constraining the size of the market. This result is discussed further in the next two subsections.

The cost reductions benefit shown in the third column of Figure 1 are out-of-model assumptions about cost reductions from efficiency gains due to increased competition.

FIGURE 1: SUMMARY COSTS AND BENEFITS FROM DIVESTMENT UNDER OPTION 5 CENTRAL CASE

Present valued $2022 millions, 5% discount rate



Source: Sense Partners modelling

The largest cost items, after reductions in producers' profits, are one-off costs associated with the restructuring of the sector i.e. costs associated with the divestment process, establishing facilities to support vertical integration and new branding and store fit out costs.

Divestment is also estimated to cause an increase in industry overheads ($131 million, a 1.1% increase in overheads), associated with the establishment of two new groups.

The Central case results sit roughly in the middle of a very wide range of estimated possible outcomes. The pessimistic (Low case) assessment shows a net cost of $3.06 billion ($2022, present value) and the optimistic (High) case shows a net benefit of $4.68 billion ($2022, present value), as summarised in Table 8.

The variation in results, from the High to Low scenario, demonstrates the fine balance between benefits from more competition and lower prices and the potential for supermarket retailing costs to rise. The High case assumes only minimal increases costs while the Low case assumes substantial increases in costs.

TABLE 8: COST BENEFIT ANALYSIS SCENARIO SUMMARY, OPTION 5
Present valued $2022 millions, 5% discount rate

	Central	Low	High
Costs	$484	$949	$311
Change in industry overheads	$131	$483	$57
Divestment preparation	$243	$331	$162
Vertical integration, one-off costs	$66	$69	$62
Store re-branding	$44	$65	$29
Benefits	$1,029	-$2,112	$4,993
Allocative efficiency, comprising:	$848	-$177	$2,340
Consumer welfare gains, lower prices	$3,206	$651	$6,823
Change in producers' profits	-$2,358	-$828	-$4,483
Cost reductions, from competitive pressure	$181	$83	$294
Consumer welfare gains, from variety	$0	-$2,018	$2,359
Net benefits (benefits - costs)	$545	-$3,060	$4,682
Net benefits as % of supermarket sales	**0.15%**	**-0.87%**	**1.33%**

Source: Sense Partners modelling

We note that while these net benefits will appear large in dollar terms, as shown above they represent just 0.15% of No Divestment scenario sales in the Central case, and -0.9% and 1.3% of sales in the Low and High cases respectively.

The size of the spread, between large net costs in the Low scenario and large net benefits in the High scenario, is predominantly due to:

- The effect of supplier cost increases, which are:
  - Zero in the High case, by assumption, and thus do not curtail the benefits that consumers can get from increased competition and lower prices, so that the allocative efficiency gain increases by $1.4 billion compared to the Central case (to $2.3 billion).
  - Between 2.0% and 2.5% in the Low case and cause the supermarket sector to contract due to overall higher prices, such that the allocative efficiency gains in the Central case become a net efficiency cost of $177 million in the Low case.
- The effects of divestment on supermarket quality or variety, with an estimated:
  - $2.4 billion gain in welfare in the High case as increased competition drives a richer offering of supermarket store types and products.

- $2.0 billion loss of welfare in the Low case as lower profitability limits investment in store quality and range, with net overall variety reduction assumed.

Distributional effects

Low-income households and larger households with children benefit most, proportionately, from lower supermarket prices. This can be seen in Table 9, in which Q1 is the lowest-income quintile and Q5 the highest.

This distributional effect reflects the fact that lower income households spend a higher share of their incomes on food and other groceries.

The effects of divestment in areas with three or more supermarkets are quite progressive with noticeably larger gains (in percentage terms) accruing to lower income households, as shown in the left panel of Table 9.

The fact lower income households spend more of their income at the supermarket also means that when prices *rise*, they are the worst affected. Once we account for potential price increases in areas with few supermarkets, the impact of Option 5 is noticeably less progressive, as shown in the right panel of Table 9.[22]

TABLE 9: IMPACT BY INCOME QUINTILE, OPTION 5, 2028

Average equivalent percent change in income, adjusted for household size

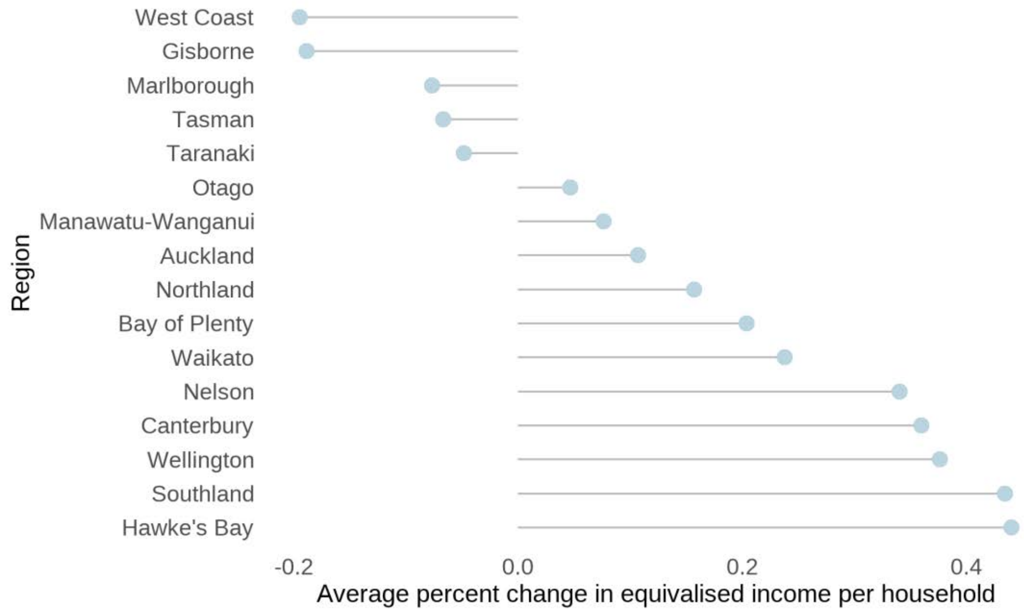
	Areas with 3+ supermarkets			**Average for all areas**		
Quintile	Central	High	Low	Central	High	Low
Q1	0.31	0.52	0.11	0.21	0.52	0.02
Q2	0.33	0.54	0.11	0.21	0.54	0.01
Q3	0.28	0.49	0.08	0.19	0.49	0.00
Q4	0.27	0.48	0.06	0.19	0.48	0.00
Q5	0.24	0.44	0.04	0.19	0.44	0.00

Source: Sense Partners modelling

The variation in effects across smaller, less urban, areas of the country is summarised with a regional perspective where we see that the average effect on households in some smaller regions like Northland is positive while impacts in, for example, the West Coast and Gisborne are negative (Figure 2).

[22] Note that the High scenario has the same results in both panels because we assume no increase in marginal costs (supplier costs or double marginalisation), so no price increases for areas with fewer than 3 supermarkets.

FIGURE 2: IMPACT BY REGION, OPTION 5 CENTRAL CASE, 2028



Source: Sense Partners modelling

4.5.3. Option 5+ scenarios

TABLE 10 DESCRIPTION OF CENTRAL, LOW AND HIGH SCENARIOS FOR OPTION 5+

Scenario	Description
Central	Variety gains are 0.5% larger than in Option 5 as there are more choices of stores with four groups to choose between and firms other than FS1 increasing range as a means of competitive differentiation. This more than offsets the reduction in range by FS1 as firms seek to differentiate their offerings. Efficiency gains from competition are 0.5% higher than under Option 5, reflecting a greater degree of competitive intensity. Both WW2 NewCo and FS1 contract warehousing from their pre-divestment parent companies (FS2 and WW1) for the first five years. We assume a 3% mark-up is charged. Supply prices rise by slightly more than in Option 5, as now there are four buyers instead of three, all with individually lower market power (especially WW2 NewCo). Industry overheads are higher than in Option 5 due to replication of group overheads when the Woolworths group is split. Divestment costs remain the same as a % of overheads but are applied to a larger number of stores as divestment occurs to two NewCos instead of one as in Option 5. Vertical integration costs for FS1 for its own warehousing remain the same as in Option 5. WW2 faces much higher warehousing costs than FS1 when its sets up its own facilities because FS1 is better able to minimise warehousing requirements through direct to store deliveries (especially with reduced range), whereas WW2 is less able to do so and therefore needs more warehousing. Rebranding and fit-out costs are the same per store as in Option 5. We assume the new WW2 faces higher costs per store than FS2 and WW1 because of the diversity of store types, sizes and locations it inherits and its need for new livery etc.

Scenario	Description
	WW2 leases IT services and equipment after separation, at an assumed cost of $15m per year. It also spends $20m developing its brand, advertising and marketing.
Low (overall more pessimistic)	There is a small (0.5%) loss in variety to consumers. FS1 reduces its range, and variety increases by its rivals are not quite sufficient to offset that reduction. Efficiency gains from competition are 0.5% lower than assumed in the Central scenario. Both WW2 NewCo and FS1 contract warehousing from their pre-divestment parent companies (FS2 and WW1) for the first five years. A 9% mark-up is charged on both, as in Option 5. Supply prices rise by slightly more than in the Central scenario. Suppliers enjoy greater bargaining power relative to each chain than in the Central scenario. The creation of new supermarket groups leads to a doubling of group overheads in the industry as functions are simply replicated across each of the new four main groups in the market. Divestment costs increase by 1% above the Central scenario as the divestment process is more complex and costly than assumed there. Vertical integration costs for FS1 and WW2 are higher than in the Central scenario. Rebranding and fit-out costs are twice as expensive as in the Central scenario for FS1, FS2 and WW1. WW2's warehousing construction costs are 20% higher than expected in the Central scenario. WW2's IT lease costs are $20m per year and its branding activities cost $30m, both higher than in the Central scenario.
High (overall more optimistic)	Variety gains are 1% higher than those in the Central scenario as divestment to two new groups improves the net range of offerings more than assumed in Central. Efficiency gains from competition are 1% higher than assumed in the Central scenario. Only WW2 NewCo faces a mark-up on its contracted warehousing costs, and this is half that assumed in the Central scenario, at 1.5%. Supply prices do not change from the No divestment scenario, as in the Option 5 High scenario. More duplication of corporate overheads assumed than in Option 5, due to the new Woolworths groups, but the effect is relatively modest as there is some scaling of these functions given reduced size of each group's activities. Divestment costs are 1% lower than the Central scenario as the divestment process runs more smoothly than assumed there. Vertical integration costs for FS1 and WW2 are lower than in the Central scenario. Rebranding and fit-out costs are the same as in the Option 5 High scenario for FS1, FS2 and WW1, and proportionally lower for WW2. WW2's warehousing construction costs are 20% lower than in the Central scenario. WW2's IT lease costs are $10m per year and its branding activities cost $10m, both lower than in the Central scenario.

Source: Consultants' assumptions

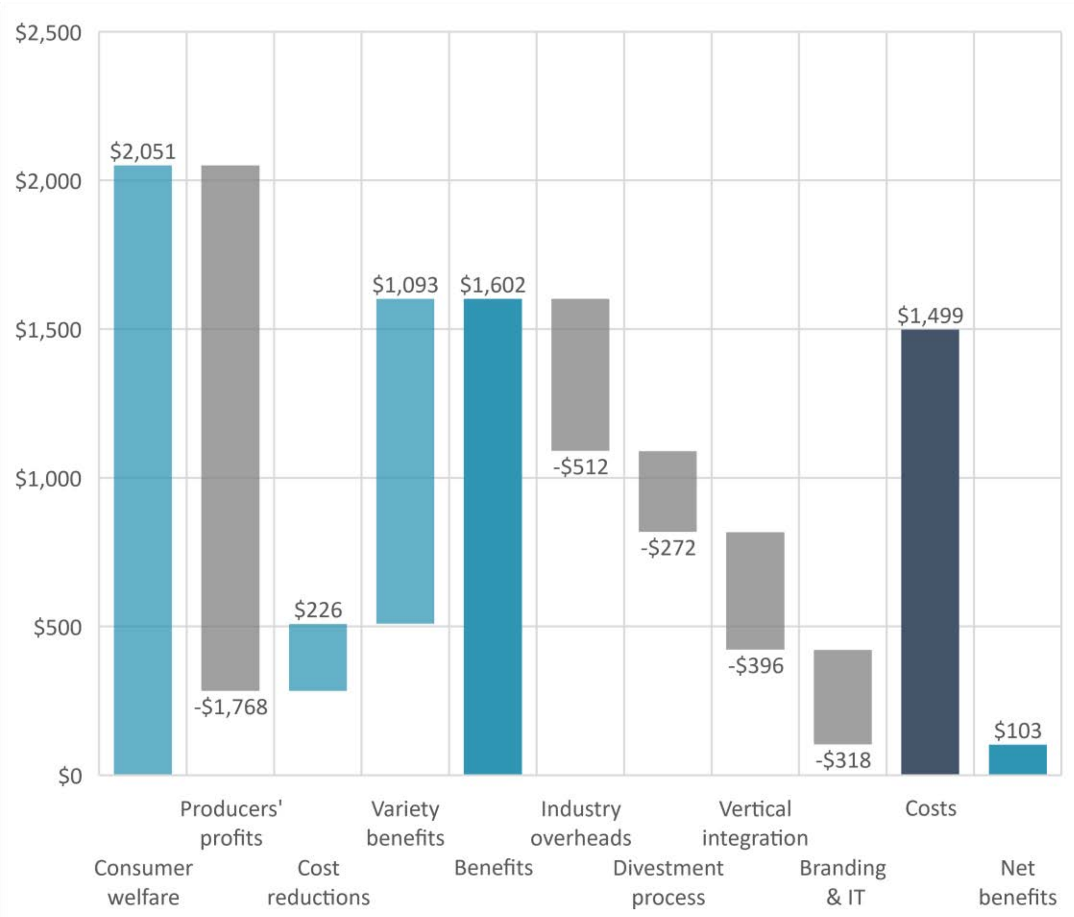
4.5.4. Option 5+ results

Our Central case estimate of the effects of Option 5+ is a present valued net benefit of $103 million (2022 dollars). This is a substantial reduction on the $545 million benefits for Option 5.

Option 5+ is estimated to deliver higher gross benefits than Option 5 ($1.6 billion compared to $1 billion for Option 5), but much higher costs ($1.5 billion compared to $484 million for Option 5).

FIGURE 3 SUMMARY COSTS AND BENEFITS FROM DIVESTMENT UNDER OPTION 5+: CENTRAL SCENARIO

Present valued $2022 millions, discount rate 5%



Source: Sense Partners modelling

Gross benefits are higher because of the substantial variety benefits ($1.1 billion) assumed to arise from the establishment of four supermarket groups competing to distinguish themselves from each other.

The costs of Option 5+ are much higher than for Option 5 because of additional costs associated with establishing the new Woolworths group. Branding and IT costs of $318 million (present value) under Option 5+ include higher re-branding and store fit-out costs than in

Option 5, because more stores are changing hands, and also costs not relevant to Option 5 – costs associated with brand establishment and costs for new IT systems ($164 million).

Furthermore, there is greater duplication of group overheads so that industry overheads increase $512 million in present value terms compared with an increase of only $131 million in Option 5.

Allocative efficiency gains are lower in Option 5+ because having a larger number of smaller supermarket groups means higher increases in supplier costs and consequently less scope for market expansion through price reductions, compared to Option 5.

Significantly higher costs in Option 5+, across all scenarios, mean that the spread of results is narrower than for Option 5. However, it remains fairly wide, ranging from a $3.8 billion cost to a $3.9 billion benefit (see Table 11).

TABLE 11: COST BENEFIT ANALYSIS SCENARIO SUMMARY, OPTION 5+

Present value $2022 millions, discount rate 5%

	Central	Low	High
Costs	$1,499	$2,150	$966
Change in industry overheads	$512	$834	$263
Divestment preparation	$272	$369	$182
Vertical integration, one-off costs	$396	$447	$340
Store re-branding	$128	$239	$59
Brand marketing, establishment	$25	$42	$13
New IT systems, one-off costs	$164	$219	$110
Benefits	$1,602	-$1,606	$4,865
Allocative efficiency, comprising:	$283	-$722	$2,163
Consumer welfare gains, lower prices	$2,051	-$416	$6,765
Change in producers' profits	-$1,768	-$306	-$4,602
Cost reductions, from competitive pressure	$226	$125	$343
Consumer welfare gains, from variety	$1,093	-$1,009	$2,359
Net benefits	$103	-$3,757	$3,899
Net benefits % of No divestment scenario sales	0.03%	-1.07%	1.11%

Source: Sense Partners modelling

As with Option 5, these net benefits are small as shares of No divestment scenario sales, at 0.03% of sales in the Central case, and -1.1% and 1.1% of sales in the Low and High cases respectively.

Distributional consequences

The competing impacts of price increases on low-income households can be seen clearly in the distributional effects of Option 5+ summarised in Table 12 overleaf.

TABLE 12 IMPACT BY INCOME QUINTILE, OPTION 5+, 2028

Average equivalent percent change in income, adjusted for household size

	Areas with 3+ supermarkets			All areas		
Quintile	Central	High	Low	Central	High	Low
Q1	0.18	0.46	0.00	0.08	0.46	-0.09
Q2	0.18	0.48	-0.01	0.08	0.48	-0.10
Q3	0.16	0.44	-0.02	0.08	0.44	-0.09
Q4	0.16	0.44	-0.02	0.09	0.44	-0.08
Q5	0.15	0.42	-0.02	0.10	0.42	-0.06

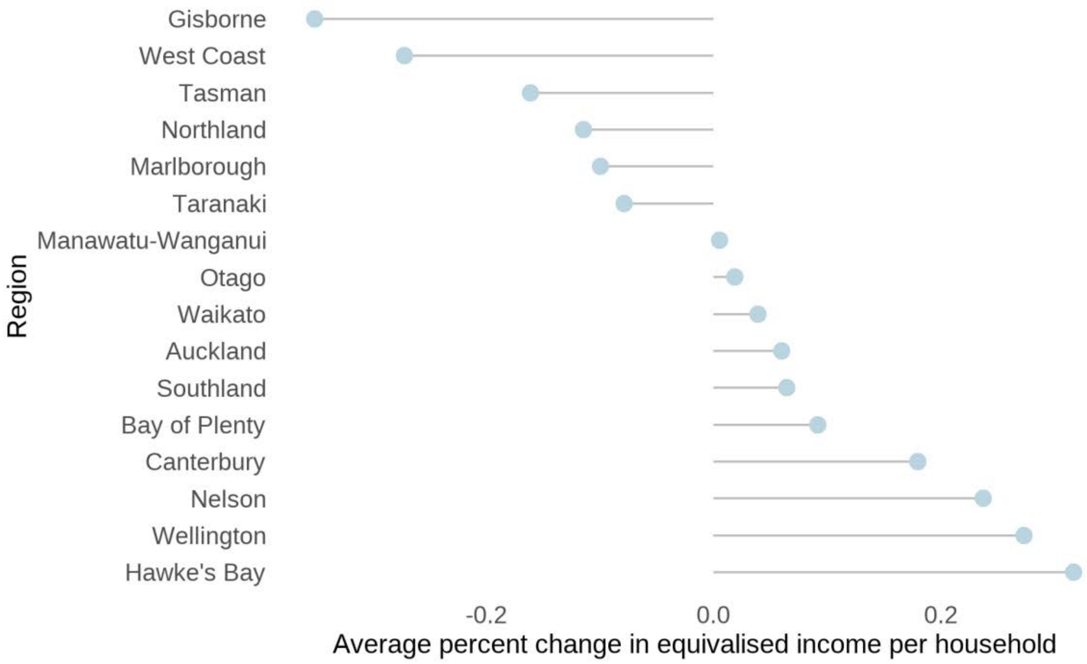
Source: Sense Partners modelling

In areas with three or more supermarkets the distributional effects are progressive. Even in the Low case there are sufficient gains in lower income areas that the lowest quintile households are not negatively affected by the policy.

However, price increases in areas with fewer than two supermarkets mean that overall Option 5+ exhibits a regressive effect. For example, in the Central case higher income households are benefiting by more than low-income households and in the Low case the impact of price increases is felt proportionately more by low-income households.

Furthermore, the negative effect on consumers in smaller regions seen in Option 5 is stronger in Option 5+ as summarised for the Central case in Figure 4.

FIGURE 4: IMPACT BY REGION, OPTION 5+ CENTRAL CASE, 2028



Source: Sense Partners modelling

4.6. Sensitivity analysis

The Central scenarios switch from net positive to net negative for society with small changes to variety and supply price assumptions

Table 13 shows the CBA modelling results are most sensitive to assumptions about:

- Changes in variety and consumer benefits from those changes.
- Increases in supplier costs.

Changing these assumptions (in isolation) changes the direction of net benefits from positive to negative in:

i. The Central case in Option 5 and the Central case in Option 5+ where if we assume that variety effects are reduced by 0.5% (from 0% and 0.5% respectively), the results switch from a net benefit to a net cost (see Table 13 below).

ii. The Central case for Option 5 switches sign if we apply high supplier cost increases (of 2.3% to 2.5%) to that scenario (an increase on the 1% to 1.5% cost increases applied in the original Central case).

These changed assumptions do not change the sign of net benefits or costs in the other scenarios.

The changes due to the variety assumption underscore that the variety assumptions have large effects and that Option 5+ would not be net beneficial in the Central case but for an assumption of a 0.5% variety benefit.

The sensitivity of the CBA to changing this assumption reflects a substantial source of uncertainty about the effects of the divestment options. The impacts can be large and hence they swing from potentially large negative or large positive.

Assumptions about supplier cost changes also have sizable effects on the net costs or benefits in the CBA.[23] They too have the power to reverse qualitative findings regarding directions of effect, at least in both Central scenarios.

These two assumptions have a particularly important effect on the welfare of households who live in areas of fewer than three supermarkets and who may not benefit from increased local competitive pressure.

The results are not overly sensitive to assumptions about discount rates, demand elasticities, or alternative local market caps in the policy design, at least not relative to the other more influential assumptions of variety and supplier cost changes.

[23] There is no change in the high scenario because supplier cost increases are assumed to be zero under Option 5 and trivial under Option 5+.

TABLE 13: SENSITIVITY TESTS, CHANGES TO NET BENEFITS

Present value $2022 millions, discount rate 5%

	Option 5			Option 5+		
	Central	Low	High	Central	Low	High
Main results, net benefits	$545	-$3,060	$4,682	$103	-$3,757	$3,899
% of supermarket sales	0.2%	-0.9%	1.3%	0.0%	-1.1%	1.1%
Net benefits after variation in assumption/parameter						
Variety effect + 0.5%	$1,638	-$2,051	$5,862	$1,196	-$2,748	$5,079
Variety effect - 0.5%	-$548	-$4,069	$3,503	-$989	-$4,766	$2,720
No supplier cost increases	$2,036	-$544	$4,682	$1,983	-$871	$3,899
High supplier cost increase	-$348	-$3,060	$2,294	-$784	-$3,757	$1,084
Low elasticity	$487	-$2,963	$4,393	$121	-$3,583	$3,626
High elasticity	$608	-$3,146	$4,968	$87	-$3,928	$4,191
Change in net benefits						
Variety effect + 0.5%	$1,093	$1,009	$1,180	$1,093	$1,009	$1,180
Variety effect - 0.5%	-$1,093	-$1,009	-$1,180	-$1,093	-$1,009	-$1,180
No supplier cost increases	$1,492	$2,516	$0	$1,880	$2,885	$0
High supplier cost increases	-$893	$0	$1	-$887	$0	-$2,815
Low elasticity	-$57	$97	-$289	$18	$174	-$274
High elasticity	$63	-$86	$286	-$16	-$171	$291
Change as net benefits as a % of sales						
Variety effect + 0.5%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Variety effect - 0.5%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%	-0.3%
No supplier cost increases	0.4%	0.7%	0.0%	0.5%	0.8%	0.0%
High supplier cost increases	-0.3%	0.0%	-0.7%	-0.3%	0.0%	-0.8%
Low elasticity	0.0%	0.0%	-0.1%	0.0%	0.0%	-0.1%
High elasticity	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%

Source: Sense Partners modelling

4.7. Recommendations for future in-depth analysis into divestment

In our view, the unprecedented nature of the divestment options being considered and the various commercial and reputational risks identified warrant additional analysis in slower time, with better data and with greater exploration of the key assumptions required for such an assessment. This would reduce the risks of unintended consequences arising from a significant regulatory move.

Though approximations are somewhat avoidable, our CBA relies on some coarse data and simplified assumptions. Key considerations for future analysis should include:

- More detailed definitions of local markets based on standard criteria used in competition analysis. Our local markets are based on a simple geographic categorisation.
- The use of detailed data on profitability of stores within local markets or at least capturing variability of store revenues and gross profits across markets. Our analysis

proceeds from a national level understanding of supermarket profitability and this limits our ability to identify location-specific competition conditions beyond the number of stores.

- More detailed data on, or analysis of, the range of store types operating with local markets.
- More refined analysis of consumer preferences over both grocery prices and quality/variety, including at more granular geographic and product levels, enabling more sophisticated analysis of divestment's impacts for different household demographics.
- Deeper analysis around key divestment effects such as store format changes, consumer gains from variety and supply price rises, changes in which have been shown to potentially change the net benefit results into net costs in some scenarios. Additional analysis into the productivity benefits from additional competition would also be useful.
- Greater clarity around the impacts of already-announced measures on the grocery sector in New Zealand – particularly regarding access to 'fair' wholesale pricing – to better inform our No divestment scenario.
- Exploring the commercial viability of any NewCos emerging from the divestment process. We assume they remain profitable and viable, but this is not a given, especially in Option 5+ which contemplates creating a NewCo that inherits a mélange of types of smaller stores spread across New Zealand.
- Likely to prejudice international relations
- Detailed development and analysis of how divestment will be implemented, including how associated costs and risks will be mitigated.

5. What are the risks associated with these options and how could these be mitigated?

5.1. What are the operational risks from any potential divestment?

The benefits of any industry-led divestment should not be oversold. Divestment will not – in-and-of itself – materially change the types of stores operating in the New Zealand grocery sector.

Instead, divestment will move the game from two players to three or four players. All will still be running traditional supermarkets and some box warehouse stores. Divestment alone will not bring about any significant disruptive competition or entrants.

Both positive and/or negative outcomes could come out of any divestment into one or more NewCo(s) (under any option). While it is tempting to hope for the best, we cannot assume positive outcomes will happen automatically. New Zealand supermarket history shows numerous examples of situations where things did not work out as expected and owners exited the market.

Implementing an industry-led divestment would create material operational risks, although all could be manageable with sufficient planning. The key risks are summarised in Table 14 overleaf.

TABLE 14 POTENTIAL OPERATIONAL RISKS AND MITIGATIONS

<table>
<tr><th>Risk</th><th>Causes of risk</th><th>Potential mitigations</th></tr>
<tr><td colspan="3">OPTION 5 & 5+</td></tr>
<tr><td>Getting implementation wrong could cause high-profile risks.</td><td>• Food is essential to human existence. Delays getting food to supermarkets due to logistical problems as supermarkets move between groups and IT systems, or the closure of regional stores post-divestment, could be problematic for households.</td><td rowspan="2">• Government review of proposed plans by industry.
• Implementation via a clearly staged process.
• Clear timelines and milestones are agreed upon.
• Incentives for existing groups line up with desired outcomes.</td></tr>
<tr><td>Implementation could be more complex and take longer than expected.</td><td>• The modern supermarket industry is a highly complex and interconnected system with many moving parts. Currently this system is focused on feeding a population of 5.1m across 30,000-40,000 items, at relatively low margins.
• Splitting these systems up via divestment without any drop in performance could be challenging.</td></tr>
<tr><td>Existing retailer could game the process.</td><td>• Existing retail groups have asymmetric information not available to government policy makers or regulators.</td><td>• Government review of proposed plans by industry.
• Incentives for existing groups line up with desired outcomes.</td></tr>
<tr><td colspan="3">OPTION 5+</td></tr>
<tr><td>Ex-Woolworths NewCo could struggle to emerge as an aggressive, robust competitor.</td><td>• Woolworths has somewhat fewer incentives to make the spin-off work than Foodstuffs. Ex-Woolworths NewCo could potentially be under-resourced, with poorer quality staff, equipment, systems, etc.
• Woolworths could play hardball with NewCo during the multi-year transition to stand-alone status.</td><td>• Woolworths could be mandated pre-agreed criteria and monitored on ongoing performance against these (for example by the new Grocery Commissioner).</td></tr>
<tr><td>NewCo could be poorly run or fail.</td><td>• New Zealand supermarket retailing has multiple examples of poorly managed firms. NewCo has a range of major tasks to deliver on, any of which on its own would be a major endeavour.
• With ~15% of the New Zealand market in Option 5+, NewCo would be smaller than the other three groups (PNS Co-op, NW Co-op and Woolworths NZ).</td><td>• Government review of proposed plans by industry.
• Implementation done as a clearly staged process.
• Clear timelines and milestones are agreed upon.
• Requirements for independent board members could be set.</td></tr>
</table>

Source: Coriolis

Likely to prejudice international relations

Likely to prejudice international relations

5.3. Property rights and borrowing cost risks

See SP&C (2022, pp.51-54)

The security of private property rights is widely regarded to be an important factor affecting things like long-run economic growth, investment and financial development.[24] If government takes steps to force supermarket owners to alter their current ownership arrangements, or which otherwise reduce the returns from investing in supermarkets, those steps necessarily affect the property rights of those owners.

Many owners are local – e.g. the owners of individual stores forming part of the North Island and South Island Foodstuffs cooperatives, and SuperValue and Fresh Choice franchise owners. Many others are foreign – i.e. the non-New Zealand shareholders in Woolworths Australia, which owns Woolworths New Zealand and hence Countdown stores.

Given the likely significance of divestment for supermarket owners, natural questions that arise include whether it is lawful or proper for government to force such a measure, and irrespective of whether it is or not, Likely to prejudice international relations

[24] For example, see Acemoglu and Johnson (2005) for evidence on the economic importance of property right institutions, or the wider discussion in Besley and Ghatak (2010).

Likely to prejudice international relations

The former question is out of scope for this study. Likely to prejudice international relations

Likely to prejudice international relations

[25] Based on August 2022 non-resident holdings of central government debt amounting to $51.5 billion. Figure from Reserve Bank of New Zealand: https://www.rbnz.govt.nz/statistics/series/new-zealand-debt-securities/holdings-of-central-government-debt-securities.
[26] Based on July 2022 total housing and personal consumer borrowing amounting to $353.5 billion, and total business borrowing of $128.8 billion. Figures from Reserve Bank of New Zealand: https://www.rbnz.govt.nz/-/media/accca2e393e5453c8afc6a8b16533867.ashx.

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Appendix A Summary of CBA assumptions

TABLE 15 SUMMARY OF CBA ASSUMPTIONS FOR OPTION 5

ALL % EXPRESSED AS INCREASE/DECREASE ON EQUIVALENT COSTS IN NO DIVESTMENT SCENARIO (NDS) UNLESS OTHERWISE STATED

Assumption	Central scenario	Low (overall more pessimistic) scenario	High (overall more optimistic) scenario
Benefits from variety (% of household spending)	+0%	-1%	+1%
Benefits from competitive efficiency gains (% of NDS overheads)	+2%	+1%	+3%
Double marginalisation costs (% of NDS warehousing costs)	0%	+9% of FS1 upstream costs in first 5 years	0%
Supplier price rises (% of NDS supply prices)	WW: +1.5% FS1: +1% FS2: +1.5%	WW: +2.5% FS1: +2% FS2: +2.5%	WW: 0% FS1: 0% FS2: 0%
Higher industry overheads from duplication of corporate (group-level) functions (% of NDS parent group overheads)	WW: 100% FS1: 50% FS2: 75%	WW: 100% FS1: 100% FS2: 100%	WW: 100% FS1: 50% FS2: 60%
Divestment preparation one-off fixed costs (% of affected stores' revenue)	WW: +3% FS1: +3% FS2: +0.5%	WW: +4% FS1: +4% FS2: +1%	WW: +2% FS1: +2% FS2: +0.25%
Rebranding/fit-out one-off costs (per store received)	WW: $0.25m FS1: $2.5m FS2: $0.25m	WW: $0.5m FS1: $3m FS2: $0.5m	WW: $0.1m FS1: $2m FS2: $0.1m
Vertical integration one-off fixed costs	For FS1 only: $50m per year in 2029 and 2030 for warehousing	For FS1 only: $55m per year in 2030 and 2031 for warehousing	For FS1 only: $45m per year in 2028 and 2029 for warehousing

Source: Consultants' assumptions

TABLE 16 SUMMARY OF CBA ASSUMPTIONS FOR OPTION 5+

ALL % EXPRESSED AS INCREASE/DECREASE ON EQUIVALENT COSTS IN NO DIVESTMENT SCENARIO (NDS) UNLESS OTHERWISE STATED

Assumption	Central scenario	Low (overall more pessimistic) scenario	High (overall more optimistic) scenario
Benefits from variety (% of household spending)	+0.5%	-0.5%	+1.5%
Benefits from competitive efficiency gains (% of NDS overheads)	+2.5%	+1.5%	+3.5%
Double marginalisation costs (% of NDS warehousing costs)	WW2: +3% FS1: +3%	WW2: 9% FS1: 9%	WW2: +1.5% FS1: 0%
Supplier price rises (% of NDS supply prices)	WW1: +2% WW2: +2.5% FS1: +1.5% FS2: +2%	WW1: +3% WW2: +3.5% FS1: +2.5% FS2: +3%	WW1: 0% WW2: 0% FS1: 0% FS2: 0%
Higher industry overheads from duplication of corporate (group-level) functions (% of NDS parent group overheads)	WW1: 100% WW2: 100% FS1: 50% FS2: 75%	WW1: 100% WW2: 100% FS1: 100% FS2: 100%	WW1: 75% WW2: 75% FS1: 50% FS2: 60%
Divestment preparation one-off fixed costs (% of affected stores' revenue)	WW1: +3% WW2: N/A FS1: +3% FS2: +0.5%	WW1: +4% WW2: N/A FS1: +4% FS2: +1%	WW1: +2% WW2: N/A FS1: +2% FS2: +0.25%
Rebranding/fit-out one-off costs (per store received)	WW1: $0.25m WW2: $1m FS1: $2.5m FS2: $0.25m	WW1: $0.5m WW2: $2m FS1: $3m FS2: $0.5m	WW1: $0.1m WW2: $0.5m FS1: $2m FS2: $0.1m
Vertical integration one-off fixed costs	FS1: $50m per year in 2029 and 2030 for warehousing WW2: $250m per year in 2029 and 2030 for warehousing	FS1: $55m per year in 2030 and 2031 for warehousing WW2: $300m per year in 2030 and 2031 for warehousing	FS1: $55m per year in 2028 and 2029 for warehousing WW2: $200m per year in 2028 and 2029 for warehousing
Costs to establish new brand	WW2: $10m per year in 2024 and 2025	WW2: $15m per year in 2025 and 2026	WW2: $5m per year in 2024 and 2025
IT system costs (assume leased)	WW2: $15m per year	WW2: $20m per year	WW2: $10m per year

Source: Consultants' assumptions