Submission

By

THE NEW ZEALAND INITIATIVE

to the Commerce Commission

on

the Market study into the retail grocery sector draft report

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1 INTRODUCTION AND SUMMARY

1.0 This submission in response to the Commerce Commission's (**Commission**) *Market study into the retail grocery* sector draft report,[i] is made by The New Zealand Initiative (the **Initiative**), a think tank supported primarily by major New Zealand businesses. In combination, our members employ more than 150,000 people.

1.1 The Initiative undertakes research that contributes to the development of sound public policies in New Zealand and the creation of a competitive, open and dynamic economy and a free, prosperous, fair and cohesive society.

1.2 The Initiative's members include two New Zealand supermarket operators, Woolworths New Zealand and Foodstuffs North Island. However, the views expressed in this submission are the views of the authors, not those of our members.

1.3 In summary, we submit:

(a) the Commission has not established its methodology based on an assessment of market outcomes is a sufficiently reliable test of whether there is workable competition in supermarkets. Findings from this approach depend on the Commission's judgment about outcomes under a workably competitive counterfactual. Those outcomes may be unknowable. The Commission is vulnerable to accusations of assuming its answer. The outcome metrics used by the Commission are not reliable indicators of competition in the presence of fixed and sunk costs and network effects (which may be relevant even in bricks-and-mortar businesses). High concentration and other market outcomes which the Commission is concerned about are common in other markets which appear to be highly competitive and deliver large consumer benefits. Conversely, if the substantive barrier to entry is land use planning restrictions, even a perfect monopoly could be observed as providing only normal profits because supernormal profits would be capitalised into the value of land zoned to be the only allowed supermarket. Profits are a poor guide to whether the market here is workably competitive.

(b) A more reliable basis for the Commission's assessment is to focus on competition processes, especially market entry. The Commission's work on barriers to entry, in Chapter 6, is commendable. Where the combination of tight zoning rules and title encumbrances mean entry is effectively impossible for anyone wishing to launch a full-service nationwide supermarket chain, anticompetitive effects should be expected.

(c) The Commission should focus, in the first instance, on easing barriers to entry so that the threat of entry and the potential for actual entry might provide stronger market discipline. In the short term, this requires:

a. the voiding of any title encumbrances that have an anticompetitive effect;

b. Urging the Overseas Investment Office to view any entry into grocery retail as being presumptively in the national interest and subject to automatic approval

In the longer term, this requires:

a. Including competition is an aim in council spatial planning by including it in the Spatial Planning Act, currently in development;

b. Setting a role for the Commerce Commission in providing input into spatial planning processes regarding the pro- or anti-competitive effects of proposed spatial plans. Ideally, the Commission would be able to veto spatial plans that have anticompetitive effect.

This would require the Commission to look closely at and be involved in the current Resource Management reform process. It would have beneficial effects far beyond this current supermarket inquiry.

2 THE COMMISSION'S COUNTERFACTUAL APPROACH IS FLAWED

Methodology

2.0 The Commission's task is to determine whether "competition is working well" (1.17). The Commission uses a "workable or effective competition" standard (1.12). It notes this standard does not mean the theoretical concept of perfect competition.

2.1 The Commission describes the method it uses for its competition analysis as follows:

> *[W]e first consider the market outcomes we can observe. Our observations focus on commonly understood measures that are indicative of whether competition is working well or not. This includes the profitability of grocery retailers and the prices they charge to consumers, but also includes the extent of innovation that they engage in, as well as the quality, range and services that are offered to consumers.*
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> *Looking across these observed market outcomes we consider whether they are consistent with what we would expect in a workably competitive market, and if not, the extent to which they depart from what we would expect. In forming expectations of what we would expect in a workably competitive market, we consider a range of benchmarks including observations from other markets, such as those overseas or in other industries.*
>
> *We then look at the nature of competition in the retail and wholesale grocery sectors to identify market features and aspects of competition that might be contributing to the market outcomes that we have observed. In our final recommendations chapter, we present a spectrum of options for recommendations for improvements to those features and aspects, which in turn, we would expect to produce better long-term market outcomes for consumers, including the right prices, quality, range and service. (1.17-1.19)*

2.2 The Commission's method detects failures or departures from workable competition as the difference between

- observed market outcomes, and
- outcomes under a hypothetical workable competition counterfactual.

2.3 Thus, the Commission's conclusions substantially depend how it defines this counterfactual. In principle, its method demands the Commission isolate competition effects on market outcomes from other variables. Some of those other variables are specific to New Zealand, making comparisons with other countries difficult. It is not clear the Commission has any objective basis for determining counterfactual outcomes.

2.4 Accordingly, there appears to be no objective basis for inferences about competition from market outcomes, including return on capital, profit margin, and market share.

2.5 We consider the Commission should base its competition analysis not on market outcomes but by treating competition as a *process*, with a particular emphasis on entry. The Commission has already done a substantial amount of work under a process view in its draft report.

2.6 The advantage of a competition analysis based on process is that findings from that approach are independent of, and therefore robust to, the specific production and technology characteristics of the market. The Commission is on safer ground by taking a process view with a focus on barriers to entry.

Consequences of fixed costs and networks for competition analysis

2.7 In standard microeconomic theory, in competitive markets, the price of each good is driven to the marginal cost of production in the long run. This follows from the fact that if price is above marginal cost, then a firm can produce additional units profitably and will do so until the opportunity for profits from further production is exhausted i.e. price and marginal cost equate in equilibrium.

2.8 Where production is characterised by scale economies, prices will not equal marginal cost in equilibrium since firms cannot earn enough revenue to cover their costs. This is especially true if scale economies are driven by fixed and sunk costs. The classic example of scale economies is software manufacturing, where costs are almost entirely fixed with respect to the production volumes; the marginal cost of each software copy is zero.

2.9 In the presence of fixed and sunk costs, the relationship between cost and price is ambiguous and an unreliable competition indicator. Prices must exceed marginal costs with scale economies even in a workably competitive market if firms are to recover their fixed and sunk costs. Entry into a workably competitive market will only occur if prices exceed the levels needed for a firm to recover costs.

2.10 Economies of scale and another phenomenon, the economics of networks, also make market share an ambiguous indicator of competition. A defining characteristic of networks is the concept of positive feedback in which success begats more success. Networks are a key concept for understanding the economies of software and internet-based markets. However, networks can also be relevant in bricks-and-mortar businesses. Network economics are relevant in software, for example inventory management, as well as supplier arrangements and distribution.

2.11 Economies of scale and network economies can help explain the emergence of high market concentrations in markets which appear workably competitive. Generally (but not always) these dynamics are the product of competitive forces and benefit consumers. Consider for example intense rivalries between Boeing and Airbus, or Apple, Google and Microsoft, or Netflix and Apple TV, or Uber and Ola. Workable competition presumably includes the concept of contestability, which recognises not only the threat of entry, but the competitive pressure exerted by small firms already in the market which can expand to fill opportunities where they arise.

2.12 The Commission should recognise how markets characterised by high concentration, significant mark-ups over costs, and non-zero economic profits, can deliver high innovation rates to the benefit of consumers. Oligopoly combines competitive pressure, 'deep pockets' and a balance sheet needed to finance innovation and bear risk, and scale sufficient to internalise a large enough share the rewards from innovation to justify the investment.

2.13 While innovation is not a guaranteed product of highly concentrated markets, it is common enough to rule out any automatic presumption that high market concentration harms consumers. Oligopolies generate a significant proportion of innovation in economies, and more so than monopolies (lack of competition) or competitive static markets mostly supplied by atomistic firms (limited ability to finance innovation or capture returns from innovation).[1]

2.14 The upshot is that market share is neither a reliable metric of workable competition nor of long term consumer benefits.

[1] Baumol, William (2002), The free-market innovation machine, Princeton University Press, New Jersey.

2.15 Measures of profit, including return on average capital employed, are also ambiguous. The test of workable competition is actual or potential entry by rivals. This is a forward-looking test for competition. By contrast, measures of profit based on historic book value is inherently backward-looking.

2.16 The essential question for the Commission is whether a firm could profitably enter the current market but for barriers to entry. The Commission should be wary of the many ways in which historical data might not reliably answer that question. For example, a recent report by the Major Electricity Users Group (MEUG) alleged excessive profits are being earned by electricity generators in this country. This conclusion was based on an analysis of historic asset values. The wholesale electricity market is characterised by free entry – anybody can sell electricity via their local lines company or by connecting to the national grid. MEUG's findings are plausibly, though not certainly an artifact of applying a backward-looking analysis to the forward-looking question of whether the profits from competitive entry have been exhausted.

2.17 The Commission should also be wary of measures of profitability that weigh capital costs if the fundamental constraint against entry is a regulatory restriction provided by zoning. Imagine a limit case in which a city council allows only one supermarket for a city of a million people. While it may seem obvious that that supermarket would earn monopoly profits, the value of the regulatory permission to operate the supermarket is tied to the value of the zoned land. The fair price of that zoned land includes the present discounted value of all future monopoly rents, risk-adjusted for any potential rezoning allowing more competition. A purchaser of that site will only earn a normal return on capital outlay because the monopoly rents are included in the price paid for the land.

2.18 So, in network markets, price above marginal cost and apparent supernormal profits may not be a reliable gauge of lack of competition. But in markets sharply constrained against entry, the absence of apparent supernormal profits are also not a reliable gauge of the presence of competition where those profits weigh the capital cost of the zoned land. A focus on any measure of profitability risks yielding false positives or false negatives in a network market subject to sharp land use restrictions.

Competition as a process

2.19 A more reliable basis for the Commission's assessment is to focus on competition processes, especially market entry.

2.20 The advantage of a process view for competition analysis is that entry is a condition for market competition that is common to static and dynamic competition paradigms and is unaffected by matters like scale and network economies. Unlike outcomes data, the competition yardstick for entry is unambiguous.

2.21 Thus, the Commission is on safer ground if, after defining the market, it bases its competition assessment primarily on entry. The Commission should limit its use of market outcomes information for descriptive rather than analytical purposes.

From a competition as a process perspective, sponsoring entry plainly threatens competition by threatening to deter competitive entry or even (perhaps) leading to the exit of an incumbent.

3 BARRIERS TO ENTRY

3.0 Markets kill excess profits. When an industry earns higher than normal profits, that profitability signals to other firms to enter the market if they can. Entry increases supply; the increase in supply and increased competition erode profits for existing players. Entry happens until the next entrant can expect only to earn normal profits by entering.

3.1 Even in the absence of entry, the potential for entry can limit excess profits even in otherwise uncompetitive environments. Baumol (1982) demonstrated that potential entrants can induce duopolists or oligopolists to price at marginal cost.[ii] The extent to which contestability induces marginal cost pricing has been empirically disputed. But that excess profits attract entry, all else equal, is axiomatic.

3.2 Maintenance of persistent excess profits is consequently more difficult in the absence of barriers to entry. If substantial regulatory barriers to entry exist, removal of those barriers, where possible, should be a first step in any remedy aimed at improving competitiveness. If the identified excess profits are real, removing regulatory barriers to entry can help in encouraging new entrants.

Identified Barriers to Entry

3.3 The Commerce Commission's Draft Report identified substantial barriers to entry in establishing new large-footprint supermarkets.

3.4 At 6.102, the Commission identified planning regulations as a potential source of barriers to entry. A site for a new supermarket must comply with zoning requirements within a District Plan. The set of restrictions may be highly constraining. A new site must have adequate transport access and, for entrants wishing to compete for the important part of the market doing a large weekly shop and transporting a large number of goods by car, it must find a site with a footprint large enough for both the supermarket and parking, or it must be economic for it to incur the cost to build a parking facility under or above the supermarket.

3.5 The Commission notes, at 6.104, that because the Resource Management Act 1991 (**RMA**) is being reformed, its effects on competition would not be substantially investigated as part of this inquiry, but that the benefits of increased actual or potential competition should be considered as relevant during planning processes under successor legislation to the RMA.

3.6 The Commission did not investigate the number of zoned sites that might be considered suitable for a new supermarket in major centres. If a large number of zoned sites are available for potential use as supermarkets, other constraints on entry may be less material. If a small number of zoned sites are available, other constraints on entry would be far more important.

3.7 At 6.55, the Commission notes that site availability is significant. Only limited numbers of places will suit, and many of those may be constrained by zoning.

Knowing the extent of the restriction imposed by zoning seems materially important. If current zoning leaves only a very small number of sites available for use as potential supermarkets, that would result in a substantial restraint on potential competition – and one that should be considered as part of RMA reform. It also substantially affects the impact of the other barriers to entry identified by the Commission.

3.8 The Commission notes at 6.65 that many sites potentially suitable as supermarkets are encumbered against their use as supermarkets. In some cases, the property's title may include a provision restricting against its use in a grocery retail – sites formerly owned by existing supermarkets may have those restrictions. In other cases, exclusivity arrangements in malls (as discussed at 6.86) may restrict against additional supermarkets at the site.

3.9 If zoning were maximally liberal and permissive, it would be nearly impossible for title encumbrances and exclusivity arrangements to stymie new entrants. If a supermarket could literally be built anywhere a supermarket operator or potential operator thought might be commercially viable, anywhere in the city, incumbents would need to buy, encumber, and on-sell a large fraction of a city's urban area to restrict against a new entrant. It seems so impracticable as to be plausibly impossible.

3.10 In a world of maximally liberal and permissive zoning, it would be difficult for supernormal profits to be maintained in grocery retail – unless other substantial barriers to entry existed. Numerous international grocery chains exist. A new domestic or international entrant would join the market to eat the incumbents' lunches. High maintained profits and a lack of entry, in that case, could point to other potential barriers to entry, or to misperceptions of actual sector profitability.

3.11 If, instead, zoning sharply restricts the number of sites where supermarkets are allowed, and many such sites are encumbered against becoming supermarkets, and long and unpredictable lags in consenting processes make it extraordinarily difficult to plan any coherent roll-out of a new chain of supermarkets even if sites could be accumulated, then entry is effectively impossible and supernormal profits could easily be expected.

3.12 The Commission's investigation at Chapter 6 is, in short, excellent. But we suggest the Commission give more consideration not just to the cumulative effects of the restrictions (6.77), which are substantial, but also about their underpinnings. Under permissive zoning regimes, restrictive covenants and exclusivity arrangements could not plausibly tie up enough sites to really restrict entry. Given existing zoning rules, encumbrances very plausibly matter considerably. This matters for problem identification. Measures that do not address entry will not solve the fundamental problem.

Draft recommended policy measures

3.13 The Commission notes a wide range of possible policy measures, ranging from RMA reform, to removal of property title encumbrances, through to structural separation of wholesale and retail and government-backing of a new entrant.

3.14 As always, it is best to begin with an appropriate problem definition. Chapter 6 suggests a substantial and real problem to be addressed. If Councils only allow a very small number of places to become supermarkets in urban areas, and if most of those places are either currently supermarkets or are encumbered against becoming supermarkets, entry is de facto impossible. All solutions really need to begin there, and to recognise the fundamental importance of restrictions against entry.

3.15 If the Commission mandated separation of retail and wholesale to encourage a new entrant to access existing wholesalers, but that new entrant was blocked by zoning and consenting processes, the Commission would only have succeeded in harming the efficiencies that can result from vertical integration to no benefit to competition. It would not solve the underlying problem.

3.16 Similarly, a new government-backed entrant into grocery retail would face every single one of the zoning and consenting issues that prevent other new entrants' entry. Where would a proposed KiwiGrocer find the sites for its supermarkets? We may recall that Kiwibuild failed because the underlying zoning and consenting issues, along with infrastructure financing, had not been sorted out. The binding constraint in housing was never the absence of a government-backed builder. The binding constraint was that zoning has made it too difficult to build houses.

3.17 The only way that KiwiBuild, or KiwiGrocer, might overcome those problems would be through complementary measures like Urban Development Authorities as competitive source of rapid and efficient consenting and, in the case of KiwiGrocer, compelled plan changes allowing a wide variety of places to be supermarkets. But if those complementary measures were in place, there would be no need either for KiwiBuild or KiwiGrocer. Policies that do not target the underlying problem will not solve the underlying problem. And policies that do target the underlying problem sharply reduce the need for other interventions.

3.18 We consequently strongly urge that any solutions be focused on what seems to be the very real and substantial underlying problem of land-use restrictions that stymie entry.

3.19 In the first instance, the Commerce Commission should assess the actual number of sites that could become supermarkets in existing council plans, and the proportion of those sites that are not already encumbered by covenants restricting against their use in grocery retail.

3.20 At 6.90.2, the Commission notes that covenants that have the effect or likely effect of substantially lessening competition are unenforceable under Section 28 of the Act. Where zoning tightly restricts the sites that could be used in grocery retail, every covenant against using a site in grocery retail could have the effect of substantially lessening competition. Demonstrating that to an appropriate standard of evidence would likely require first showing that zoning sharply limits the number of feasible sites that could be used in grocery retail.

3.21 Exclusivity arrangements in shopping centres may have more substantial efficiency considerations in favour of their maintenance. A supermarket as anchor tenant may make substantial investments in the site that would be discouraged if the benefits of that investment were taken up by direct competitors, and this could affect the financing of new shopping centres. We would urge the Commission to be cautious in approach.

3.22 Voiding exclusivity arrangements that have anticompetitive effects will help. But the fundamental problem remains. Town planning decisions do not weigh competition as a good to be encouraged. And, in alcohol licensing, which materially affects grocery retail for full-service grocery outlets, the existence of nearby outlets is frequently taken as presumptive evidence against allowing new competitors. There are regular credible stories of existing alcohol licensees quietly backing community-based objections to new licensees.

3.23 The Commission suggests, at 6.104, that ongoing RMA reform processes are a reason that the Commission would not discuss current planning regulation in detail. We urge the Commission to reconsider this position. RMA reform is fraught and happens only infrequently. There will not be another opportunity for pro-competition measures to be embedded into RMA systems, potentially for decades.

3.24 Bluntly, town planners can often take a SimCity approach to spatial planning, deciding that if a neighbourhood already has planning allowance for one supermarket, a second one might be aesthetically displeasing and should not be accommodated. They do not consider competition in these processes.

3.25 Potential RMA reforms could include a direct role for the Commerce Commission in advising on the pro- or anti-competitive effects of proposed Local and Regional spatial plans.

3.26 Bolder reform would allow the Commerce Commission to void anticompetitive aspects of spatial plans, and to consider long consenting processes as anticompetitive.

Overseas Investment Act

3.27 The Commission did not note the potential role of the Overseas Investment Act as further stymying entry. Land zoned for residential use is deemed sensitive, so land with mixed-use zoning allowing both supermarkets and residences could be affected. Land adjacent to parks is deemed sensitive. Land adjoining marine or coastal areas or lakes is deemed sensitive.

3.28 If any new entrant needs a bundle of sites across the country, some of those sites are likely to encounter Overseas Investment Act encumbrances. And while the Overseas Investment Office advertises high approval rates, it is the uncertainty, complexity, and delay that this process adds that is the material constraint.

If the Commission has just determined that a new grocery entrant is so strongly in the national interest that even a government-backed entrant could be warranted, it seems perverse that the Overseas Investment Office should have to decide as to whether an overseas entrant would be in the national interest. The Overseas Investment Office should instead be encouraged to loudly announce that any new entrant is welcome, would have immediate OIO approval, and would face only the same barriers that any New Zealand entrant would face.

4 Conclusion

4.1 We thank the Commission for the opportunity to provide comment on its draft report. The barriers to entry identified in Chapter 6 appear material and in need of remedy. The fundamental underlying cause of those barriers are zoning restrictions that sharply reduce the number of sites that are allowed for use in large-footprint grocery retail. Any effective remedy must deal directly to the source of the underlying problem if greater competition in grocery retail is desired.

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[i] https://comcom.govt.nz/__data/assets/pdf_file/0025/260377/Market-study-into-the-retail-grocery-sector-Draft-report-29-July-2021.pdf

[ii] Baumol, William J, 1982. "Contestable Markets: An Uprising in the Theory of Industry Structure," American Economic Review, American Economic Association, vol. 72(1), pages 1-15, March.