MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Dr Duncan Webb	**Portfolio**	Commerce and Consumer Affairs
Title of Cabinet paper	Provisional supermarket divestment cost benefit analysis and proposed next steps	**Date to be published**	13 July 2023

List of documents that have been proactively released		
Date	**Title**	**Author**
December 2022	Provisional supermarket divestment cost benefit analysis and proposed next steps	Office of the Minister of Commerce and Consumer Affairs
7 December 2022	Appendix 1: Supermarket divestment options and cost benefit analysis	Coriolis, Sense Partners, Cognitus
7 December 2022	Appendix 2: Comparison of costs of divestment with Commerce Commission estimates of supermarkets' excess profits	Sense Partners
7 December 2022	DEV-22-MIN-0305: Provisional Supermarket Divestment Cost Benefit Analysis and Proposed Next Steps	Cabinet Office
June 2023	Proposed approach to work on divestment in the retail grocery sector	Office of the Minister of Commerce and Consumer Affairs
12 June 2023	CAB-23-MIN-0231: Work on Divestment in the Retail Grocery Sector: Proposed Approach	Cabinet Office

Information redacted **YES**

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Some information has been withheld for the reasons of being legally privileged, free and frank advice, confidential advice to Government and to preserve international relations of the Government of New Zealand.

In Confidence

Office of the Minister of Commerce and Consumer Affairs

Cabinet

Proposed approach to work on divestment in the retail grocery sector

Proposal

1 I propose that work on requiring major grocery retailers to divest assets (by selling a portion of their supermarkets) be held in reserve for the time being.

2 I propose that the immediate period be used to actively engage and monitor the industry responses to, and the consumer impacts of, the current phase of reforms while work on divestment is held in reserve. I propose the same approach regarding facilitated entry.

3 Key reasons for this proposal are:

3.1 to allow time for the impact of the current grocery interventions to be established, including the nature of the need for further reform;

3.2 uncertainty about the nature and sequence of the benefits and risks to consumers of divestment;

3.3 the financial costs and other resources required to implement divestment;

3.4 the risk that pro-competitive actions by third parties (such as innovators or new entrants) would be disincentivised by divestment; and

3.5 the opportunity to focus work on areas of more certain gain, especially consumer data rights.

Relation to government priorities

4 This paper relates to the Government's continuing commitment to promote effective competition in the grocery sector by building on the Government's response[1] to the New Zealand Commerce Commission's (the Commission) March 2022 market study into the retail grocery sector.[2]

Executive summary

5 In December 2022, the Cabinet Economic Development Committee (DEV) considered the results of a cost benefit analysis (CBA) of divestment in the retail grocery sector [DEV-22-MIN-0305 refers]. Divestment would require the

[1] https://www.mbie.govt.nz/dmsdocument/21390-response-to-the-commerce-commissions-retail-grocery-sector-market-study-proactiverelease-pdf.
[2] https://comcom.govt.nz/about-us/our-role/competition-studies/market-study-into-retail-grocery-sector.

incumbent major retail grocery businesses[3] (major grocery retailers) to reduce their market shares by selling, or separating, parts of their businesses to improve competition in the retail grocery sector.

6 The CBA showed that a range of outcomes is possible from divestment, from net benefits through to net costs, and that divestment contained risks and uncertainties. On some scenarios there was negligible or negative returns for consumers. These scenarios were understandably measured against assumed changes to the current market environment and not the actual impact of the grocery reforms once they are bedded in.

7 DEV noted that further policy work would be required to better understand these risks and uncertainties. It invited the Minister of Commerce and Consumer Affairs (the Minister) to report back with further detail on this work, including cost, in order to consider proceeding with divestment.

8 It also invited the Minister to provide further detail on work related to facilitated entry in the retail grocery sector in terms of investigating policy options which could help support new retailers to enter or existing retailers to expand at scale to compete with the major grocery chains.

9 We are midstream in an initial round of grocery sector reforms. These include:

9.1 a June 2022 law change banning anti-competitive covenants that has freed up over 100 sites for potential development by competitors;

9.2 the passage of the Grocery Industry Competition Bill currently at Committee of the Whole House stage, that will enable the establishment of the new Grocery Commissioner to monitor industry;

9.3 the establishment of a framework for wholesale supply, and a regulatory backstop incentivising commercial agreements;

9.4 a Grocery Supply Code addressing the imbalance between major retailers and their suppliers

9.5 unit pricing requirements to stimulate competition on value.

10 My preferred approach is to take a period of time to actively engage and monitor the industry's responses to this initial round of reforms while holding further work on divestment in reserve.

11 The Commerce Commission will be monitoring the state of competition in the grocery sector. This enhanced facility and the associated Grocery Commissioner will be helpful in any future consideration of the need and nature of further reform, including divestment.

[3] Woolworths New Zealand, Foodstuffs North Island and Foodstuffs South Island. The Foodstuffs businesses do not compete with each other and share assets such as brands. As a consequence, the New Zealand market is, in effect, a duopoly between Foodstuffs and Woolworths.

12 In the meantime, I expect grocery retailers to fully cooperate with these reforms and take meaningful steps to meet their obligations under the new legislation.

Background

The Government is implementing grocery sector reforms recommended by the Commerce Commission's market study

13 In November 2020, the Minister directed the Commission to carry out a market study into the state of competition in the retail grocery sector. The Commission's study found that competition in the sector is not working well for consumers. Amongst other factors, it identified a high market concentration of supermarket chains in New Zealand (effectively a duopoly structure), and high barriers to entry and expansion as key concerns.

14 The Commission made 14 recommendations to address these issues. The Government accepted 12 of these recommendations, and in the case of the remaining two (grocery wholesale supply and annual reporting requirements), decided to go further than what was recommended. Some of the more significant reforms include:

14.1 prohibiting restrictive covenants;

14.2 establishing a grocery regulator;

14.3 developing an access regime for wholesale grocery supply;

14.4 requiring mandatory unit pricing; and

14.5 introducing a mandatory grocery supply code.

15 In June 2022, the Government passed the Commerce (Grocery Sector Covenants) Amendment Bill. This Bill amended the Commerce Act 1986 to ban anti-competitive covenants that prevented the development of land for a retail grocery site. This has freed up over 100 sites for potential development as retail grocery sites.

16 The majority of the Commission's recommendations are being progressed through the Grocery Industry Competition Bill which is currently before the Committee of the Whole House and should be passed soon. The Bill establishes a Grocery Commissioner who will monitor the industry and make recommendations to Government. This function includes annual reporting on the state of competition within the sector.

17 The Bill also establishes a framework for wholesale supply of groceries and a regulatory backstop to incentivise the major grocery retailers to reach commercial agreements with wholesale customers. Woolworths Group and Foodstuffs have already entered into wholesale agreements with smaller retailers. I note, however, that these wholesale reforms involve significant change, and it will take time for the market to adjust and for the outcomes to be known.

18 The Bill also creates a Grocery Supply Code to address the imbalance between the major retailers and their suppliers. The Code will prevent regulated grocery retailers from passing on certain costs and risks to suppliers that they are better placed to manage and create more transparency and certainty for suppliers about the terms and conditions of supply. MBIE have opened consultation on a draft Code, and I expect to bring final policy decisions to Cabinet in due course.

19 I am also progressing work around unit pricing to ensure consumers have the standard information on the price of their groceries.

20 All these interventions are occurring against a background of other significant changes, including the entry of Costco into the market, and the expansion of grocery offerings by the Warehouse and other retailers, and interest being shown for entry into the retail grocery market by other significant players. These changes have been prompted by the market study and the Government’s reforms.

Alongside these reforms, officials have completed initial work on divestment

21 Two areas which the Commission’s study considered, but did not recommend at this time, were divestment and facilitated entry in the retail grocery market.

22 Divestment relates to policy options seeking to introduce an additional competitor or competitors through requiring the three major grocery retailers (Woolworths New Zealand, Foodstuffs North Island and Foodstuffs South Island) to sell parts of their businesses to another competitor and/or divide their existing businesses into separate, competing, entities.

23 Facilitated entry relates to policy options which help support large-scale entry by new players or for existing retailers to scale-up and compete with the major grocery chains. This could include regulation changes (e.g. to help free up sites for new supermarkets) through to financial support such as government loans.

24 While the Commission’s market study included a high-level consideration of divestment and facilitated entry, it did not undertake any detailed analysis into these options. Instead, the Commission recommended that the government should implement other competition-enhancing measures, and subsequently review the impact of these measures, before considering whether other measures were required such as retail divestment.

25 In early 2022, the Minister directed officials to undertake a detailed cost benefit analysis (CBA) on retail divestment. This CBA was presented to Cabinet in December 2022.

26 At this time, DEV noted the risks and uncertainties set out in the CBA. It invited the Minister to report back on the scope and cost of policy work required to address these uncertainties and progress work on divestment. This would allow further consideration of whether further work should progress.

27 DEV also invited the Minister to report back with further detail regarding facilitated entry as another potential option for improving competition in the sector. In line with the proposal I am outlining in this paper to hold divestment in reserve, I am proposing the same approach on facilitated entry.

Divestment could increase competition but also has significant uncertainties and risks

The CBA showed a wide range of outcomes is possible

28 The CBA included a quantitative analysis of two divestment options. The first option split the existing duopoly into three competing firms, while the second option expanded on the first with a fourth new grocery retailer entering the market.

29 Modelling of these two options showed a high degree of uncertainty of the potential benefits of divestment. Net benefits were calculated over a twenty-year period. Under Option 1, the CBA found net benefits could be somewhere between $4.7 billion in the high scenario, through to negative $3.1 billion in the low scenario. Option 2 ranged from $3.9 billion through to negative $3.8 billion.

30 The CBA indicated that consumers were likely to benefit under the majority of the scenarios modelled. These benefits would come via reduced prices and non-price benefits such as greater choice of stores/banners in a particular geographic area and increased range of products offered (so-called variety effects). However, in some scenarios consumers would be worse off, both in terms of reduced variety, and in one scenario, higher prices.

31 These scenarios were based on a range of provisional assumptions made during the assessment, including those related to the counterfactual, i.e., how the market could evolve over time given factors already at play, such as the entry or expansion of new supermarket chains (Costco, for example) and the possible impact of already announced grocery sector reforms. Any significant improvement achieved by these means would substantially weaken the case for divestment.

32 In terms of distributional impacts, the CBA indicated that poorer outcomes are more likely to occur for consumers in rural areas. This is because smaller towns are less likely to support multiple competing retailers, regardless of divestment.

33 It also indicated that suppliers would benefit under most scenarios. Increasing the number of buyers allows suppliers to negotiate better terms, leading to higher margins on their products.

34 The main costs of divestment would of course be worn by supermarkets, which would be worse off under all scenarios modelled. These costs arise from reduced margins as a result of greater competition and higher supplier prices. There are also increased costs arising from the establishment and operation of a new supermarket chain/s.

35 To the extent that the CBA suggested divestment could be beneficial, it indicated this required alignment of several key factors and mitigation of several key risks. It suggested these risks are “more on the downside than upside”. This is because:

35.1 divestment of businesses whose structure resulted from mergers subject to previous regulatory scrutiny is unprecedented in New Zealand;

35.2 there are large risks of unintended consequences;

35.3 there are significant implementation challenges to overcome; and

35.4 some potential costs, and risks, were not clarified and quantified in the time available.

36 I also observe that in terms of “regret”, a scenario in which divestment was implemented and resulted in consumers being worse off than prior to implementation would result in very high regret.

Modelling was highly sensitive to assumptions made about supplier prices and variety effects

37 Divestment has the potential to materially increase supplier prices, due to losses in economies of scale, and because divestment is likely to improve the bargaining position of suppliers. Such increases may offset any reduction in supermarket margins from increased competition. This could lead to higher prices for consumers.

38 Modelling was also sensitive to assumptions made about the impact divestment may have on variety effects. Although important, these effects are hard to quantify and the degree to which they may eventuate is uncertain.

39 Small changes in assumptions made about supplier prices and variety effects have a major bearing on the outcome of the CBA. It will be important to understand these issues in more detail before decisions on divestment are made.

40 Consequently, there is a small but appreciable risk that the results of divestment are substantially different from that modelled either on the upside, or downside.

Some potential costs were not quantified in the CBA

41 In the time available, the CBA did not quantify some of the potential costs of divestment. International relations [redacted] The CBA indicated that these costs are almost certainly greater than zero and could be material.

42 International relations [redacted]

International relations

43 Free and frank opinions

44 Legal professional privilege

45

46 International relations

Significant work is required to better understand the CBA assumptions and narrow the range of potential outcomes

47 Significant further work would be needed to work through the CBA assumptions and narrow the range of potential costs and benefits. Such analysis would need to encompass:

47.1 the extent of supplier price impacts;

47.2 the extent of and role played by non-price (or variety) impacts on consumers;

47.3 the extent of the likely competitive price response from supermarkets;

47.4 the counterfactual, including the likely trajectory of the grocery sector in the absence of divestment which might include the emergence of a disruptor / innovator;

47.5 a more nuanced assessment of scenarios which goes beyond summing up all the negatives and positives to produce high and low scenarios;

47.6 an assessment of the likely viability of new supermarket businesses resulting from divestment;

47.7 Legal professional privilege

47.8

47.9 further analysis of distributional impacts across regions and population groups.

48 This further work would allow key parameters in the CBA to be verified, refined, and broadened, thereby resulting in a narrower range (and greater certainty) about the direction and magnitude of possible divestment costs and benefits.

The CBA suggested implementation could be highly complex

49 Overseas assessments[4] of regulated divestment suggest that implementation plays a key role in the success or failure of a divestment remedy.

50 The CBA pointed to significant risks relating to the implementation of divestment. It noted that the complexities of divestment could mean that it may take much longer than expected to implement, be subject to legal challenge, and create uncertainty in the grocery sector.

51 If divestment were to proceed, officials would need to develop a robust implementation plan which seeks to mitigate these risks. External advice would likely be needed on sales process options and other, more detailed, aspects of a divestment process.

Work on divestment could cost up to $850,000 in the short term

52 The main steps for progressing work on divestment, and addressing the issues noted above, include:

52.1 revising the CBA to help narrow uncertainties and better quantify the risks noted above;

52.2 public consultation (subject to Cabinet approval);

52.3 analysing submissions, producing a regulatory impact statement, and designing an implementation pathway; and

52.4 if appropriate, seeking Cabinet decisions on a divestment remedy.

53 This work could cost up to $850,000 over the next 18 months. This level of expenditure would require reprioritisation of funding from other work to pay for consultancy work and for contractors. This cost does not include costs

[4] https://www.ftc.gov/sites/default/files/attachments/merger-review/divestiture.pdf.

associated with implementation (including the sales process) which are likely to be substantial.

54 It would make sense to consider the need for more detailed policy work on divestment to occur after the Commission makes its first report into the state of the grocery sector, as required by the Grocery Industry Competition Bill. This would allow decisions to be made on more up-to-date information.

55 The divestment process itself would also likely involve significant cost, which would need to be estimated. The sales and valuation process would likely need to be run by a financial services firm, whose fees could be significant. Legal professional privilege

56 Divestment will also require legislative change. This will be a relatively resource intensive exercise, particularly given the complexity and significance of the intervention.

Work should focus on actively engaging and monitoring the grocery sector reforms underway, in the first instance

57 The Government is already progressing a package of reforms which seeks to improve the state of competition in the grocery sector and provide better outcomes for consumers. This work includes:

57.1 progressing the Grocery Industry Competition Bill;

57.2 work on regulations setting out a grocery supply code; and

57.3 work on regulations requiring mandatory unit pricing.

58 Given the benefits these reforms may bring, I consider that government and industry should focus on this work to ensure these reforms are implemented in a timely and effective manner, and on actively monitoring industry responses.

59 Assessment of the effectiveness of these reforms would occur through the work of the new Grocery Commissioner, and the Commission's annual reporting on competition in the grocery sector, which is required by the Grocery Industry Competition Bill.

Conclusions and possible next steps

60 While divestment could provide benefits for consumers, I note the following difficulties with progressing work on divestment:

60.1 there are significant risks and uncertainties associated with this intervention;

60.2 there is a small but significant possibility that consumers could be worse off after divestment;

60.3 there are a number of material non-financial costs International relations hat are not well understood;

60.4 costs of progressing the work are material;

60.5 progressing the reforms might divert resources from other areas where significant gains for consumers in the long term are more certain such as consumer data rights;

60.6 divestment risks driving out innovation/disruption in the sector;

60.7 progressing the work could impact progress on the reforms already announced, or their possible impact with active monitoring; and

60.8 the impact of the already announced reforms on the competitive landscape of the grocery sector has yet to be determined.

61 Considering the above, my preference is to hold in reserve the work on divestment at this stage and to re-commence it should it become clear that it is needed to achieve a properly competitive grocery market.

62 In the meantime, I expect the major grocery retailers to fully cooperate with the reforms already in train and to take meaningful steps to open wholesale access to their competitors and meet their obligations under the new legislation.

Financial implications

63 This paper has no financial implications.

64 Any subsequent Cabinet decisions to continue work on divestment may raise financial implications that will need to be covered in relation to this work. The implementation and oversight of applying divestment would likely incur substantial government costs. If these options were to proceed from now these costs would likely impact appropriations for the 2023/24 and/or 2024/25 financial years, and potentially subsequent years.

65 The likely costs to government (and other parties) of implementing divestment would be provided in advance of any final policy decision.

Legislative implications

66 This paper has no legislative implications, although any subsequent Cabinet decision to continue work on divestment may have legal and legislative implications that will need to be covered in further policy work.

Impact Analysis

Regulatory Impact Statement

67 This paper does not directly involve the potential introduction of new legislation, or changes to or the repeal of existing legislation. However, any

subsequent Cabinet decisions on divestment could trigger this requirement and a regulatory impact statement may need to be provided as part of that work, unless an exemption applies.

Climate Implications of Policy Assessment

68 This paper has no climate policy implications.

Population Implications

69 If Cabinet decides to proceed with further work, an assessment of any potential population impacts would be provided in a subsequent paper.

Human Rights

70 This paper has no human rights implications.

Consultation

71 The following departments and agencies were consulted on this paper:

71.1 Te Arawhiti;

71.2 Te Puni Kōkiri;

71.3 Department of Prime Minister and Cabinet (DPMC);

71.4 Ministry of Foreign Affairs and Trade;

71.5 Ministry of Justice; and

71.6 The Treasury.

72 The Commerce Commission was informed.

Proactive Release

73 I intend to proactively release this Cabinet paper, the Cabinet paper on divestment considered by DEV on 7 December 2022, and the results of the divestment cost-benefit analysis, within 30 days of the Cabinet decision, unless there are grounds under the Official Information Act 1982 not to publish all or part of the material.s

Recommendations

The Minister of Commerce and Consumer Affairs recommends that Cabinet:

1 **note** that the Minister of Commerce and Consumer Affairs was invited to provide further information on the scope and cost of further policy work on divestment in and facilitated entry for new competitors into the retail grocery sector to DEV [DEV-22-MIN-0305 refers];

2 **note** that these interventions come with a number of costs, risks and uncertainties, which in the case of divestment, could be significant;

3 **note** there are a number of current interventions in the grocery sector, including the freeing up of approximately 100 locations previously subject to anti-competitive covenants, the Grocery Industry Competition Bill, the appointment of the Grocery Commissioner, the Grocery Supply Code of Conduct and unit pricing in the grocery sector that are subject to active engagement and monitoring in the industry;

4 **agree** that the next period should focus on actively monitoring the impact of the current grocery reforms, and holding divestment and facilitated entry in reserve;

5 **note** that, in the meantime, I have signalled to grocery retailers that I expect them to engage cooperatively with the current reforms.

Authorised for lodgement

Hon Dr Duncan Webb

Minister of Commerce and Consumer Affairs