

COMPETITION SPECIAL ALERT

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THE WAREHOUSE CLEARANCE DECISIONS RELEASED

The Commerce Commission ("Commission") has now released its reasons for declining clearances for Woolworths and Foodstuffs to acquire The Warehouse ("Decisions").¹

This competition Alert reports on the key findings and on the Commission's competition assessments against the backdrop of its past decisions in the area.

Highlights

Some of the key findings in the joint decision are set out below.

- **No "supercentres" without The Warehouse:** The Commission found that no parties, other than Foodstuffs, Woolworths (New Zealand) Limited ("**Woolworths NZ**") and The Warehouse, have the potential to develop the "supercentre"² concept in the way being attempted by The Warehouse.

Irrespective of whether this might be the case, the perspective of Woolworths and Foodstuffs as seasoned industry players appears to be that this concept will never succeed in New Zealand. This is likely to be a key issue on appeal.

- **The Warehouse may be a future springboard for competition:** The Commission also considered that the acquisition would preclude the potential for The Warehouse to be used as the only possible vehicle (for investment by international chains) to provide competition to the two existing supermarket firms (similar to the basis on which the High Court found the acquisition in *NZ Bus* breached the Act).

The issue of determining the character of future competition is a highly controversial area of competition law - not only in New Zealand but also internationally.

Competition authorities are generally obliged to measure competition detriment by comparing two future states, with the transaction and without it, that is, they must determine what would happen if the transaction did not proceed ("counterfactual"), and measure any lessening of competition against this scenario.

In a contested bid process, it is frequently possible for the competition authority to find another bidder, perhaps a bidder that might re-invigorate a fading company, could be successful and treat that bidder as the owner of the business in the counterfactual. Where other participants in the process are not presently in the market (for example, private equity participants or Australian companies bidding for New Zealand assets), this type of finding tends to run dangerously close to the Commission fixing its preferred market structure by "picking the winner".

A problem for parties seeking to rebut this counterfactual is that the information on which this assessment is based is invariably confidential, and may not be disclosed to parties, even on a counsel and experts basis, unless and until the decision is appealed and the Commission produces its record for the appeal.

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1. A copy of the reasons is available at:
http://www.comcom.govt.nz/PublicRegisters/ContentFiles/Documents/PUBLIC_VERSION_Decision_606_and_607.pdf

2. Although, oddly, it does not seem to have concluded that supermarkets other than supercentres would be unable to enter the market.

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- **A property portfolio is essential to future competition in one-stop retailing:** The Commission considered that the property portfolio of The Warehouse was a key feature in considering its actual or potential market impact. It found that there was generally a lack of available sites for new supermarkets, other than those belonging to The Warehouse.

Resource consents were considered particularly important as a barrier to entry, and Wairau Park was used to suggest that the process is not straightforward or timely. On the other hand, the Commission appears not to have given significant weight to the relative ease with which Woolworths and Foodstuffs have opened a number of other sites in recent years.

The Commission also placed little weight on the possibility of expansion by global supermarket retailer, Aldi, from Australia into New Zealand as an effective constraint.

- **Supermarkets will display coordinated effects if The Warehouse is taken out of the mix:** The Commission considered that coordinated effects would arise, as the merged firm and the remaining supermarket group would have less incentive to compete vigorously with each other due to the loss of the competitive constraint of The Warehouse.

The Commission found that there was a "real risk" that prices would be materially higher, and quality, service and innovation materially lower without The Warehouse in the market, than if the acquisition were not to proceed. With The Warehouse having only a small percentage of the relevant markets it is difficult to understand how this effect would occur. This finding is clearly of relevance to a number of New Zealand companies in two player markets.

The history

It is not surprising that the Commission would want to examine closely these two acquisitions, in light of its past decisions. In May 2001, Progressive applied for clearance to acquire Woolworths NZ. The application was first cleared by the Commission under the old "dominance" test in Decision 438, then declined under the current "substantial lessening" test on 14 December 2001 ("**Decision 448**"). Foodstuffs and the Commission took the question of which of the two decisions were binding all the way to the Privy Council, which allowed the first clearance to stand.

In Decision 448, the Commission took the view that, if Progressive and Woolworths NZ merged, the supermarket retail markets would not be so competitive post-merger. It believed that, because the market would be highly concentrated, and the two remaining companies would be relatively evenly matched in terms of market share, there would be few incentives for them to compete hard for business and new entry would be unlikely.

In Decision 448, the Commission also specifically considered the potential for *de novo* entry into the market by The Warehouse. It noted that The Warehouse had responded to its inquiries by advising that all its goods were competing for shelf space in its stores and grocery items were well down the order, due to their low margins. The Warehouse also advised that it was not interested in supplying fresh foods. The likelihood of The Warehouse entering the market was therefore considered to be very low.

Commentary

Woolworths and Foodstuffs are appealing the decision. A High Court judge in Wellington, sitting with a lay member - an economist - will consider the record of the evidence before the Commission, and decide whether the Commission was wrong, in fact or in law.

A key question will surely be: was the Commission correct in 2001 when it said that The Warehouse would not be a strong competitor? What has changed since then? The Commission's answer will be that The Warehouse did not have its "Extra" chain, and this has made all the difference to the character of competitor that it expects The Warehouse to evolve into over the medium term.

Woolworths and Foodstuffs strongly submitted that The Warehouse simply could not achieve the economies of scale needed to make a successful competitive impact in the market with already fierce competition between the two existing players. But proving the negative is

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not easy, particularly where evidence may be relied on by the Commission and the Court (effectively opinions gleaned from confidential interviews) that would not usually reach the high tests of evidence normally produced in Court. Woolworths and Foodstuffs will also need to meet the inherent deference that the appeal Court may place on the judgment of the Commission. Much will depend on the evidence produced in Court, and whether the Court is convinced that the Commission, potentially in light of its earlier view of the industry, was simply wrong in its assessment of The Warehouse's growth prospects in this respect.

Even if The Warehouse would grow its Extra concept in the counterfactual, would the acquisition by either chain have the effect of substantially lessening competition? This is a hard question to judge.

Investors and the general public will no doubt watch progress of the appeal with interest.

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