PUBLIC SUBMISSION TO

ACCC GROCERY INQUIRY

Australian United Retailers Limited (FoodWorks)

11 March 2008

Australian United Retailers Limited
Trading as FoodWorks
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Introduction

Soon after the Federal Government announced its intention to direct the Australian Competition & Consumer Commission to undertake an inquiry into the competitiveness of retail prices for standard groceries, the management team at FoodWorks came together to ask ourselves a number of simple, but searching questions.

> "What would it take for FoodWorks' retailers to be able to reduce their prices for standard groceries?"
>
> "Are retailer margins excessive?"
>
> "If not, can prices be reduced without negatively impacting retailer margins?"

As a marketing and merchandising services company supporting over 700 independently owned and operated supermarkets throughout Australia, every day we are challenged to find new and better and innovative ways of competing with the major supermarket chains, other independent supermarkets and specialty providers of competing or complimentary offers.

The very survival of FoodWorks is dependent on its ability to successfully compete in a market dominated by a few major players who set the prices, standards, expectations, and terms for the market as a whole.

From FoodWorks' perspective, price competition is ever present, but it is not the sole determining driver of our offer. If price was the sole determinant, we could probably seek to emulate the often cited Aldi alternative, which has a very definite strategy and very defined and limited offer in order to compete as a low price retailer.

We are constantly surveying our customers, and the customers of our competitors, to determine their preferences, their needs, their likes and dislikes, the reasons why they do or do not shop in our stores, the reasons why they buy some products and not others, and what we would need to do to attract and retain their custom.

Primarily FoodWorks' customers require convenience. They require a reasonable, but not excessive, range of products. They require quality fresh produce, meat and bakery. They require exceptional service. They require reasonably comparable prices. They require extended operating hours but do not require 24 hour opening. They require a pleasurable shopping experience. Price is ranked 4th in relative importance.

Our customers do not want us to become like Aldi, but they do want the option of shopping at Aldi. The Aldi model can only work in an environment where consumers can also access full range supermarkets.

In this context of being absolutely committed to meeting or exceeding the requirements of our customers, the management team resoundingly responded that our retailer margins are not excessive and indeed are only barely sufficient to provide an acceptable rate of return in order to remain viable and competitive over the longer term.

Whenever the MSC (Woolworths/Safeway and Coles) undertake a major refurbishment or rebranding or introduce a major new initiative, they have the capital and resources to be able to implement their plans. Our individual retailers each need to be able to respond to these initiatives from their own resources. Hence, in addition to the need to make a sufficient margin to meet their immediate financial requirements, retailers must have sufficient retained earnings to meet future investment requirements.

It was argued that if margins were excessive, there would be an influx of new prospective retailers or the prices for the sales of supermarket would be soaring. Neither of these is occurring. There is no ‘boom’ in independent supermarket retailing, there are no lines of prospective proprietors beating down our doors to establish new stores, there has been no increase in the sale prices of stores.

As the smallest national independent retail supermarket group, FoodWorks is a price taker, not a price maker. Our members have only 1 warehouse from which they are effectively able to purchase 58% of their stock. We cannot benefit from any competitive tensions between wholesalers.

We simply take the price that is determined by the wholesaler and then do everything we can to minimise the cost of marketing and selling for our members so that they can be price competitive and endeavour to earn a reasonable margin.

For the remaining stock lines – fresh produce, milk, bakery, liquor, tobacco, meat, deli - FoodWorks endeavours to negotiate the best possible prices with wholesalers and suppliers however with more limited buying power than the chains we are unable to achieve the same costs as our competitors.

FoodWorks' estimates that the average difference in cost between its retailers and the chains to be in the order of 2%. In an industry characterised by high volumes and low margins, cost reductions cannot be easily achieved at the retail end of the supply chain.

For FoodWorks' retailers to be able to reduce their prices for standard groceries there must be cost reductions further down the supply chain.

Peter Noble
Chief Executive Officer

Executive Summary

1. Independent supermarket retailers incur higher input costs than their MSC equivalents.

2. At comparable retail prices, independent supermarket retailers are required to be either more efficient in order to achieve comparable margins or recoup lesser margins.

3. FoodWorks has enjoyed considerable success and growth since its inception in 2004. It now has operations in all States and has created a strong second force in independent grocery retailing to IGA. Annual gross sales are in the order of $1.66B. Store 'like for like' growth is exceeding that delivered by the MSC in the past 12 months indicating that there is room in the market for well run independent operators.

4. A significant risk to FoodWorks' continued growth and viability is the complete absence of competition in the wholesale grocery market.

5. Metcash is the only wholesaler of dry groceries to independent supermarkets which, in the case of FoodWorks' retailers, represents 58% of their product procurement. This lack of a competitive alternative to Metcash and the relative size of FoodWorks determine that FoodWorks is a price taker, not a price maker.

6. The MSC's continue to dominate the retail sectors but with Woolworths/Safeway assuming a predominant position to the point where it effectively exercises market dominance.

7. The MSC and Metcash are taking greater control of their supply chains through bringing more products through their distribution operations and taking control of product flow from the factory and farm gate. Metcash has taken equity interests in retailers to further vertically integrate its operations in order to compete and has made public announcements about taking equity interests in suppliers.

8. The MSC have undertaken:

   - "creeping acquisitions" of dozens of large independent retailers
   - aggressive new store development programs
   - sales density increases in petrol, health & beauty, liquor (BWS)

- tactical use of State variances in liquor laws by both Woolworths and Coles (Queensland and Victoria) to build dominant positions

- supply chain back to "factory gate" and to the farm.

9. Vertical integration and consolidation of the supply chains, whilst allowing for the aggregation of critical mass and achievement of economies of scale, acts to prevent competition between wholesalers for supply to independent supermarket retailers.

10. Continued aggregation and integration, sustained initiatives to reduce the costs of doing business and pronounced achievements of economies in the supply chain by the MSC and Metcash have failed to realise reduced prices.

11. In the absence of competition in the wholesale market, independent supermarket retailers will continue to need to be more efficient than the MSC to remain comparable but there is little prospect of independent supermarket retailers being able to offer lesser prices than the MSC.

FoodWorks

Origins

Created from the Merger of the FoodWorks Supermarket Group Ltd (FSG) and Australian United Retailers (AUR) in November 2004 in response to rapid industry consolidation and increased competition, Australian United Retailers Limited (AURL) is a marketing and merchandising services provider to Australia's second largest independent retail supermarket group trading under the "FoodWorks" brand.

Foundation members of FoodWorks were originally AUR, Foodstore, FoodWorks, Buy Rite, Cut Price, 727, Rite-Way, Food-Rite, Tuckerbag and Food-Way proprietors.

FoodWorks mission is to build prosperity for its independent retailer members in the face of overwhelming industry dominance from the major supermarket chains.

FoodWorks does not own or have an interest in any of its member stores.

Today

Having secured stores in South Australia in January 2008, backed up by its strong entrance into the Western Australian market in early 2007, FoodWorks now has over 700 supermarkets, food and convenience stores spanning every state and territory nationally. More than 390 of these operate under the FoodWorks brand, clearly visible by the bold, fresh orange and green logo design and signage.

The past few years has seen the brand truly become a potent force to be reckoned with, growing to be one of Australia's largest leading independent supermarket retailing groups, supporting in excess of $31 million sales per week, which is $1.6 billion in annual aggregate store turnover.

FoodWorks also experiences a weekly customer count of 1.5 million, which is on the rise.

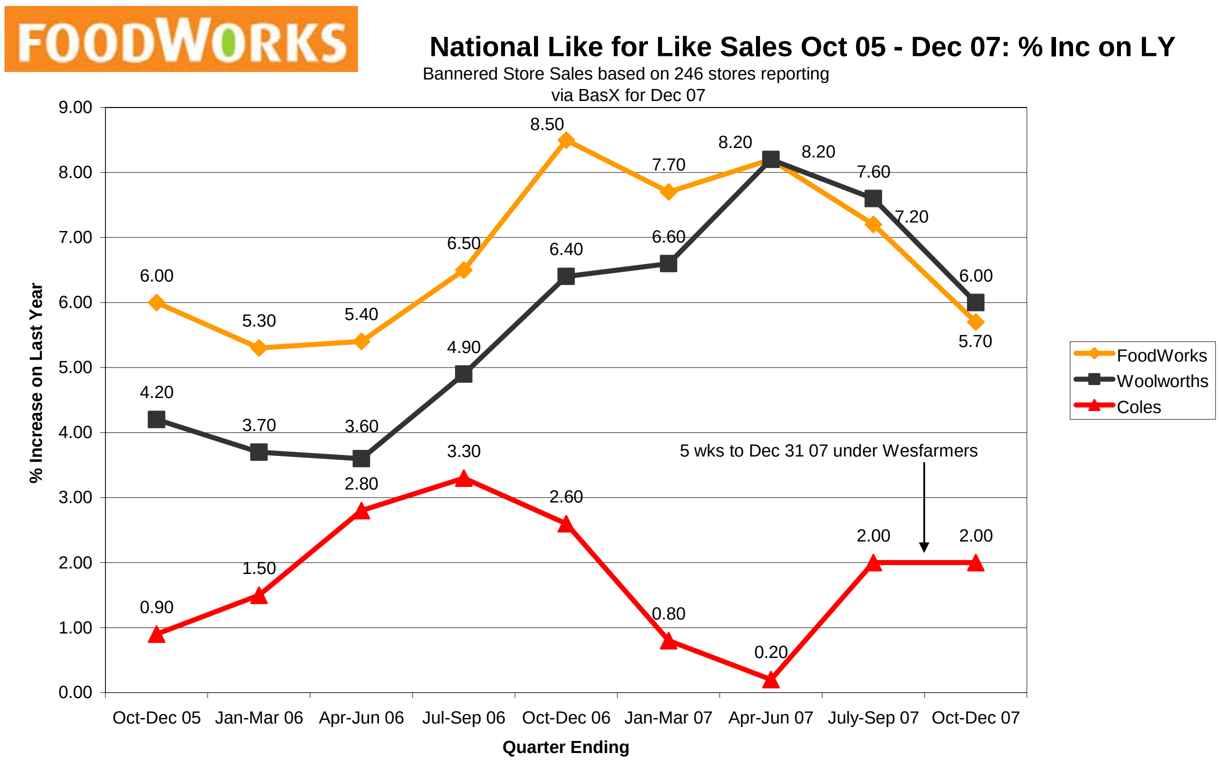
FoodWorks' stores draw supply from a range of companies. Metcash Trading Limited supplies FoodWorks with approximately 58% of product requirements (predominantly dry groceries and liquor) with the remainder coming from several hundred direct suppliers.

FoodWorks recently completed a major restructure by way of an internal prospectus and capital raising, in order to effectively represent the interests of Members in the competitive Australian supermarket industry.

Success

FoodWorks' recent comparative sales results significantly outperformed Coles' like for like growth, and ran on par with Australia's largest supermarket chain, Woolworths/Safeway.

FoodWorks continues to produce strong like for like sales growth. Half Year to Date 2007 – 2008 (July to December 2007) showed solid like for like sales up 6.4%, while the eight month Year to Date (July 2007 to February 2008) result rose to 6.6%.



Mission

FoodWorks' mission is to build the prosperity of its independent retailer Members.

The Company has built strength and value in its core business and throughout its
retail network via:

- the introduction of standardised business processes;
- greater bargaining power with suppliers;
- increased geographic density which has improved marketing and operational efficiencies; and
- a stronger independent retail supermarket identity to influence change on behalf of independent retailers.

In particular, FoodWorks has been delivering on its mission to increase retailer prosperity through a significant increase in store sales, total income to FoodWorks and distributions to members.

The prosperity of FoodWorks' members is dependent on increases in the volume of sales.

Vision

FoodWorks' vision is to offer its retailers, a smart, contemporary, retail and business system that: improves retailer prosperity; listens and responds to their needs; and strives to be Australia's premier independent retail brand.

Importantly, all key stakeholders (Board, employees, retailers and store teams) focus on customer needs as the basis for prosperity.

FoodWorks' unique strength is that the Company is owned by, and exists for, its retail shareholders, which comes from the retailer co-operative buying group heritage.

Activities

In order to fulfil its mission of building retailer prosperity, FoodWorks provides the following services to, and on behalf of Members:

- Negotiating wholesale and direct supply arrangements, including pricing, trading terms, logistics, and promotions;

- Building and marketing a range of Private Label (controlled brand) product lines, to improve store sales and margins and generate customer loyalty;

- Conducting marketing and advertising on behalf of Branded Storeowners to grow sales and enhance customer awareness of the FoodWorks Brand;

- Providing a range of support services and tools to assist Members to:

  run their businesses – such as business plans, Business Development Finance services, product sales benchmarking information, space planning;

  manage their businesses – such as training, manuals, price file hosting and maintenance and accounts payable services (e.g. Chargeback); and

  reduce the cost of doing business – such as local area marketing, media buying, production and distribution of handbills, Telstra, and Commonwealth Bank EFTPOS contracts;

- Assisting Members regarding store refurbishment and redevelopment opportunities and the management of their development projects;
- Assisting Members in their choices of Point of Sale and Back Office Systems, and associated support arrangements; and
- Representing the interests of independent retailers generally with governments, industry groups or associations.

Unbranded Member Stores are also able to take advantage of the majority of FoodWorks' services – including :

- supplier arrangements, the controlled brand ranges including Black and Gold products, and FoodWorks' Best Buy ranges,

- handbills, price file hosting and maintenance, Point of Sale systems support, the Company's store refurbishment

- redevelopment expertise and a competitive Member distribution structure.

FOODWORKS

Public Submission to the ACCC Grocery Inquiry
11 March 2008

ACCC INQUIRY INTO THE COMPETITIVENESS OF RETAIL PRICES FOR STANDARD GROCERIES

FOODWORKS' RESPONSE TO ACCC ISSUES PAPER

Issues on which the ACCC is seeking comment

Context of the inquiry

1. *What have been the major causes of rising food prices in Australia (e.g. drought, transport costs, etc.)? In particular, what have been major causes of the rising prices of products such as milk, cheese, bread, fruit and vegetables?*

There are many broad ranging issues affecting the price of standard grocery products in Australia. These factors, in various combinations depending on the circumstances, all influence the final price to the consumer. Factors include, but are not necessarily limited to:

Supplier

- manufacturers cost increases
- economic factors including inflation
- grower concentration
- impact of the drought
- impact of fuel prices

Wholesaler

- wholesaler deals
- wholesaler trading terms
- wholesaler fees
- new product releases
- distribution channels and methods to market
- number of middlemen
- broader industry consolidations
- level of competition between wholesalers
- cost of implementing technology
- demand for shareholder profits
- financing costs of more store developments and acquisitions

Retailer

- retailer margin requirements
- customer buying patterns
- availability of stock
- availability of alternatives
- competitive activity
- store location - metro or regional
- demographics of customers
- customer ability and willingness to pay
- quality of product at the point of sale
- import alternatives
- product life cycle
- store layout and product location
- cost of store upgrades
- cost of training, OH&S obligations, HACCP obligations

2. *Do the OECD comparisons accurately reflect the relative rates of food price inflation in Australia and the OECD countries? Are there other more relevant comparisons? Are there a more appropriate set of countries to compare Australia's food price inflation?*

FoodWorks has no alternative or more appropriate source data however unless the countries are reasonably comparable to Australia in terms of population size, population density, physical size, remoteness of population centres, are subject to factors equivalent to the drought, and have a comparable industry structure, then such comparisons are somewhat meaningless.

A. Structure of the Grocery Industry

Questions on grocery retailing

3. *What have been the major changes to the structure of grocery retailing in Australia over the past 5 to 10 years?*

The major change has been continued consolidation at the retailer, at the wholesale and at the supplier levels. There are now fewer, larger, participants in each segment. Fewer participants means greater economies of scale but less competition.

The major supermarket chains (MSC), Woolworths and Coles, continue to dominate the retail sectors but with Woolworths assuming a predominant position to the point where it effectively exercises market dominance.

The MSC have undertaken:

"creeping acquisitions" of dozens of large independent retailers

aggressive new store development programs

sales density increases in petrol, health & beauty, liquor (BWS)

tactical use of State variances in liquor laws by both Woolworths and Coles (Queensland and Victoria) to build dominant positions

supply chain back to "factory gate" and to the farm.

Metcash's acquisition of FAL has given Metcash a stronger aggregate buying position to compete with the MSC.

The smaller but highly effective Aldi chain has emerged with a significant market share, competing mainly on lower prices across a limited range of private label products.

In the independent retail sector, there are now effectively only two Independent brands in the retail market: FoodWorks and IGA. Previously there were numerous smaller, regional brands such as AUR, Foodwise, Tuckerbag, SupaValu, Jusons (WA).

In the case of IGA, it is fully supplied and supported by Metcash as a de facto chain. Only FoodWorks stands alone as disaggregated from Metcash.

A number of previously independent retailers have been acquired (in whole or part) by wholesaler Metcash, presumably to prevent further creeping acquisitions and hence loss of market share to the MSC.

4. *What factors have driven these changes (e.g. changes in trading hours, one-stop convenience of supermarket shopping, mergers and acquisitions, etc.)? What has been the relative importance of these and other factors?*

Traditional market forces of supply and demand.

The MSC continue to strive for greater market dominance, a greater share of the consumer spend, a greater move to 'one stop shopping' as they seek to return superior returns to shareholders.

The MSC are driven by their fervour for continued growth.

Aldi, a sophisticated multinational corporation with a proven 'offer' and method of retailing, has acquired market share, largely at the expense of the ailing Coles/Bi Lo. Aldi has recognised that there is a significant market for low cost, limited range, no frills, grocery shopping. Although successful, supermarkets cannot simply replicate the Aldi model – it can only work in conjunction with the broader range supermarkets.

In the independent retail sector, the various 'banner' groups have been forced to consolidate to derive economies of scale from their purchasing, merchandising and marketing support in an endeavour to survive in the face of the MSC. These retailers businesses support as many as 4000 individual SME families.

5. *How important are economies of density, scale and scope in grocery retailing?*

All are important.

FoodWorks is positioned to support regional Australia. Whilst we have some metro stores, most of the FoodWorks' network is regional. MSC have long since purchased major independents in metro locations.

Economies of density are important as the higher the number of stores within a particular region the more efficient it is to spread the operating costs, the advertising costs and the distribution cost. In the case of FoodWorks, the majority of our members are located in country and provincial towns thereby denying any economies of density.

The limited availability of wholesale suppliers to the independents exacerbates the cost of supply.

Economies of scope are more relevant to, say, Aldi, but are not as important to FoodWorks' customer offer where service and the customer shopping experience are given greater weight.

A typical consumer has on average somewhere in the region of 320 different SKUs (product lines) in their pantry. The average MSC will stock somewhere in the order of 25,000 SKUs.

The FoodWorks offer is based around meeting customer needs at the neighbourhood level so on average only up to 15,000 SKUs are needed to meet the demand. There is a degree of economies of scope but nothing like Aldi which might stock between 500 - 750 SKUs.

Economies of scale are important as the larger the scale the more able you are to share the costs across the whole group. For FoodWorks, the aggregation of buying power across over 700 stores enable us to achieve better deals than with a hand full of stores, but not anywhere near as good as the buying power exercised by the chains or Metcash.

6. *What are the most appropriate ways of measuring the shares of grocery retailers (value of sales, number of stores, areas of floor space, etc.)? Should industry or market shares be measured across all grocery items or for particular product categories (such as packaged food, bakery products, meat, fruit and vegetables, delicatessen products, etc.)? If possible, please provide quantitative estimates of shares of grocery retailing detailing the data sources and any assumptions made in estimating the shares. How have these shares changed over the past 5 to 10 years?*

AC Nielson data is the methodology used by FoodWorks to determine retail market share. All data from A C Nielson is readily available and as such it is unnecessary to replicate in our response.

We commend the ACCC to review the data.

Point-of-sale Scan data is collected daily from across the FoodWorks network and consolidated by A C Nielson. It is compared against the MSC. Metcash does not have scan data available due to its system capacity, so estimates are used by A C Nielson.

Industry data should be measured across all grocery items and segment down to department level.

The number of stores is not that important as the size of store can vary widely. The area of floor space available is also an inconsistent measure as the size of "back office" storage and plant varies considerably by store size and type so it is not a reliable measure.

That said, FoodWorks is a small industry player, probably in the order of 3-4% of the Australian supermarket market share.

7. *Please provide details of recent entry and exit in grocery retailing including the reasons for the success or otherwise of new entry and the reasons for exit.*

Aldi: according to media statements, currently around 6-7 % market share

Costco: to launch in Melbourne in February 2009

BI-LO: low cost brand closed down by Coles.

FAL: acquired in a takeover by Metcash in 2005.

Coles: acquired by Wesfarmers.

We have no direct information concerning reasons for success or exit.

8.	*How does the structure of grocery retailing differ between metropolitan, regional and country areas?*

The regional areas, with lower population bases, can sustain fewer retailers. Regional independent stores tend to therefore be smaller, but very community involved and focussed.

The cost of fuel acts as a major disincentive to travel further distances to major centres. Growth in FoodWorks' regional centres in the past 2 years is guidance of a lessening of customers prepared to travel 30 - 100 km to a MSC.

The higher cost of servicing and the reduced labour base makes it necessary to achieve higher margins to survive. These higher margins are above already higher cost prices thereby further increasing costs to consumers.

Access to regional wholesale warehouses with reduced distribution costs would assist cost reductions to independent retailers.

9.	*How profitable are grocery retailers? What margins over wholesale costs do grocery retailers achieve? Do margins and profitability differ by the size and location of the store? If so, how? What rate of return on capital do grocery retailers achieve? Has this changed over the past 5 to 10 years?*

Profitability of grocery retailers is dependent on a range of factors as set out in our response to question 1 and cannot simply be measured as a margin over cost or rate of return on capital invested.

FoodWorks' has retailers with stores that vary in size from as small as $140m^2$ up to large full range stores in the order of 3,000 m^2. This diversity in size, range, location, number of product lines, frequency of deliveries, marketing requirements and other variable factors means that there is no single benchmark of profitability.

Price volatility, ranges of differing price considerations, promotions, competitive strategies, volume of sales, obsolete stock and wastage, and a myriad of other factors, determine that different retailers have different expectations.

Inevitably, higher turnover means slimmer margins.

To look at the issue of profitability from a different perspective, if profitability was increasing FoodWorks would expect to see an increase in demand for retail stores or an increase in the sale price of supermarkets. We have seen neither of these trends and as such must conclude that profitability is steady.

This inquiry is directed to ensuring consumers receive a fair deal and that farmers receive a fair price for their produce. FoodWorks' is firmly of the view that there has been no price gouging or profiteering by FoodWorks' retailers and that any opportunities for price reductions must be directed further down the supply chain.

Questions on grocery wholesaling

10. *What have been the major changes to the structure of grocery wholesaling in Australia over the past 5 to 10 years?*

There is now effectively only one wholesaler supplying to the independent retail sector – Metcash.

Metcash has worked extremely hard to try to remain competitive with the MSC but the consequential impact now is the absence of competition in the independent wholesale market.

Prior to 5 years ago there were two wholesalers to the independents, Metcash and AIW, a subsidiary of Woolworths.

Now Metcash is the only wholesaler capable of servicing stores that carry 15,000 + SKUs.

Whilst the MSC have extensive and highly efficient wholesale warehouses and distribution logistics, these are not available for supply to independent retailers.

11. *What factors have driven these changes (such as cost savings from large-scale wholesaling operations, changes to the structure of grocery retailing, mergers and acquisitions, etc.)? What has been the relative importance of these and other factors?*

The strength of the MSC has meant that in order to compete against their scale the independent wholesale sector has had to consolidate and lift standards of their customer offer.

Metcash has achieved the scale needed to compete against the MSC through the acquisition of FAL. To achieve that scale has meant that there is now only the one wholesaler to supply warehouse products to the independent sector.

Metcash is driven by the need to deliver profits to its shareholders thereby endeavouring to negotiate favourable terms with suppliers (and there are a broad range of these terms, allowances, rebates, discounts etc) and profitable terms with retailers.

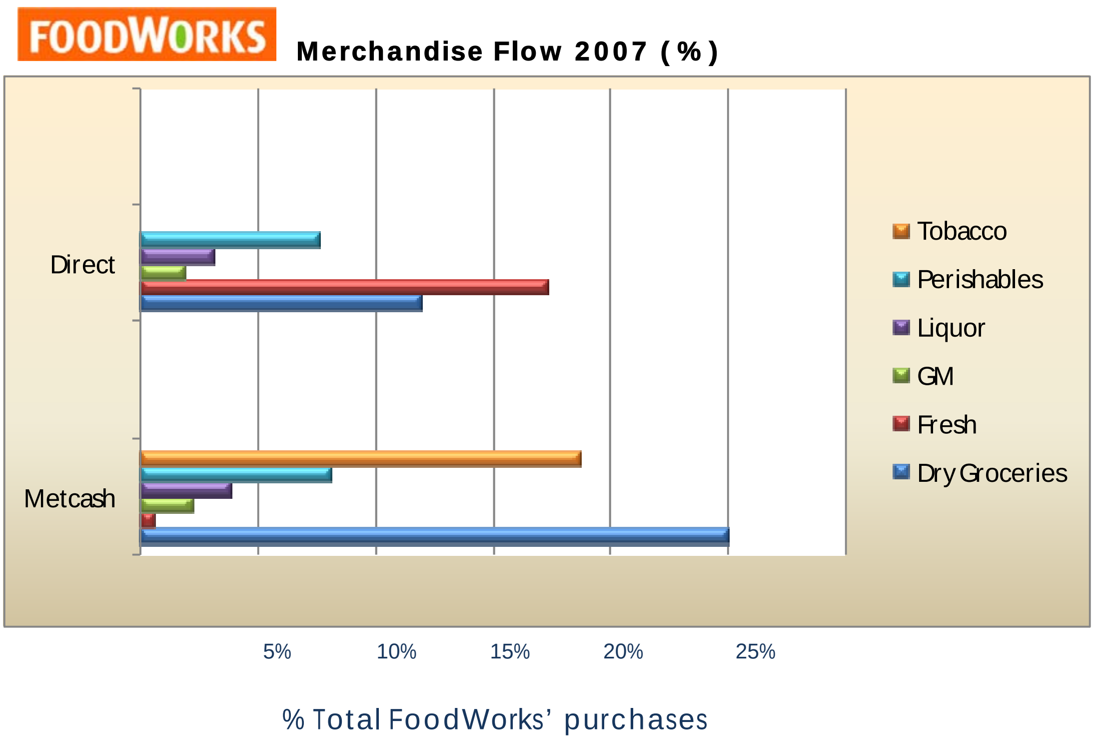
Notwithstanding the consolidation of the independent wholesalers and the economies of scale, it is still difficult for Metcash to compete with the MSC where they also have control of their retail operations. Metcash simply does not have the capital to implement the systems and technology adopted by the MSC.

The very nature of the independent market, where the wholesaler cannot control the retailers, cannot dictate their purchases, cannot command retailer compliance to initiatives, cannot dictate their operations and systems and marketing, means that the independent sector necessarily incurs higher costs and hence less margin as it competes on price with the MSC.

12.	*In what ways (if any) do grocery wholesaling operations and arrangements differ by product categories? Please provide details*

An analysis of FoodWorks' operations reveals:

Merchandise Flow 2007 (%)



58% of FoodWorks' purchases come through the Metcash warehouse.

13. *How important are economies of scale in grocery wholesaling? What are the sources of these economies of scale? Are economies of scale primarily the result of lower transport costs, lower storage costs, better stock management or the ability to negotiate better deals with suppliers?*

Economies of scale are fundamental to grocery wholesaling.

Aggregation of buying power in wholesaling primarily allows for better deals to be negotiated with the suppliers. Even better deals again can be achieved if the wholesaler is able to guarantee that the supplier's products will be stocked and promoted across the retail stores. In this regard the MSC have an advantage over independent wholesalers who cannot force retailers to take the supplier's products.

In the independent sector, economies of scale have not lead to lower transport costs or distribution costs.

14. *What are the most appropriate ways of measuring the shares of grocery wholesalers? Should industry or market shares be measured across all grocery items or for particular product categories (such as packaged food items, bakery, meat, fruit and vegetables, delicatessen products, etc)? If possible please provide quantitative estimates of shares of grocery wholesaling detailing the data sources and any assumptions made in estimating the shares. How have these shares changed over the past 5 to 10 years?*

The value of box movement out of the wholesaler is the best measure.

As per the most recent AC Nielson, the MSC and Aldi hold an 80% market share with Metcash holding a 16-18% market share.

FoodWorks does not accept the arguments of the MSC that their market shares should be determined on the basis of 'all food' or 'whole of stomach'. The better comparison is the comparative measure of packaged groceries.

15. *Are there any structural differences in grocery wholesaling in metropolitan, regional and country areas? If so, please explain.*

Dry Grocery is the same.

Perishables is the same

Liquor varies due to the differing state based liquor regulations however ALM, a division of Metcash, is consistent across the country

Tobacco is the same.

Fresh varies by state. Each state has state based markets that vary in their influence. There are numerous wholesalers in each state of varying size. Metcash has indicated publicly it is actively acquiring influencing stakes in these state based wholesalers to control the flow of Fresh products into their store network.

16. *How profitable are grocery wholesalers? What margins over supply costs do grocery wholesalers achieve? Do these margins differ by size of the wholesaler? If so, how? What rate of return on capital do grocery wholesalers achieve? Has this changed over the past 5 to 10 years?*

The MSC and Metcash are public companies and publish their financial results.

FoodWorks has no access to information other than published results.

In the case of the MSC it is difficult to differentiate between their retail and wholesale activities and where there might be cross subsidization of profits. There is no ability for FoodWorks to be able to make a direct comparison with the MSC as their operations are integrated.

A brief review of published results is instructive.

From the Woolworths half yearly results published in February 2008:

> "Sales + 8.6%"
>
> **"EBIT – up 20% growing faster than sales"**
>
> "Leverage significant strategic advantage in our supply chain"
>
> **"Profit After Tax – up 28.1%"**
>
> **"Our targeted CODB reduction of 20 basis points continues to be achieved"**
>
> **"Gross Margin has improved reflecting improved buying, shrinkage, the success of our private label offering, the change in sales mix achieved through the rollback campaign, offset by price reinvestment and varying levels of pricing activity in the market."**
>
> "• Gross margin increase demonstrates better management of

In the case of Metcash, ABC News reported on 5 June 2007:

> "Australia's largest grocery wholesaler, Metcash, has recorded a 41 per cent increase in annual profit, bolstered by the integration of the Foodland grocery business it acquired two years ago."

Coles has been acquired by Wesfarmers Limited.

Understanding the grocery supply chain

The ACCC requests that submissions provide as much detail as possible in relation to the following:

17. *identifying each of the steps in the supply chain from supplier to retailer*

FoodWorks has limited exposure to the full supply chain.

For supplies other than through Metcash, these are predominantly directly from suppliers of dry groceries who supply products that are not distributed through Metcash or suppliers of perishables.

18. *the activity or value added in each step*

19. *the businesses or business types that undertake each activity*

20. *The pricing structure in each step (price per unit, price mark-up, etc.)*

21. *the proportion of the final retail price of the product accounted for by each part of the supply chain*

B. Consumer behaviour and choice of grocery retailer

Questions on consumer behaviour and consumer choice of grocery retailers

22. *What options or choices of retailer do consumers have to purchase grocery products? How far will customers travel for their groceries? How does this differ by grocery product (packaged food, meat, fruit and vegetables, etc)? How does this differ depending on the type of shopping trip (weekly shop, top-up purchases, etc)?*

MSC, Independent supermarkets, Convenience stores, Specialist food stores, Farmers markets, On-line.

Generally metro consumers will not travel beyond their neighbourhood or along their commuter route.

Country and provincial consumers inevitably are required to travel greater distances however fuel prices have lessened the attractiveness of travelling excessive distances in search of cheaper groceries.

Top up shops are generally more local.

Most consumers have a repertoire of 2 -3 stores that they shop at weekly.

23. *Would unit pricing (a requirement that the price per kilogram or per 100 grams etc is displayed on the supermarket shelf or product) improve the ability for customers to compare prices? Should unit pricing be made compulsory? Would unit pricing lower the cost of shopping for customers?*

Unit pricing would assist consumers to compare prices and is supported by FoodWorks.

FoodWorks does not believe unit pricing should be compulsory as we see it providing a competitive advantage through which competitive forces would demand its introduction.

It would not lower unit pricing as compliance and system costs add to the cost for independents. With over 20 different back office computer and pricing systems across retailers there is no single simple fix. Again, this is an advantage the integrated chains have over the independents.

24. *How important to consumers is the convenience of purchasing from a retailer offering a broad range of grocery products (meat, fruit and vegetables, packaged products, etc)?*

There are consumers who seek convenience one stop shopping however from our studies the majority would prefer *top quality* products in a *close* location.

Many consumers will still purchase their fresh produce from specialty retailers where there is a perception of both higher prices and better quality.

25. *How important is price for consumers when they decide where to buy groceries? Does this differ depending on the grocery product*

As has been explained earlier, Price alone is not the sole critical factor for FoodWorks' consumers.

It is important to the extent that prices must be reasonably competitive, but from our studies customers are more focussed on convenience, their shopping experience, service, and the location of the store. Price was ranked the fourth highest priority.

26. *How important are factors such as distance of travel, freshness of perishable items, Product range, etc? Does this differ depending on the grocery product? If so, how and why?*

Dry Grocery is about price and range choice.

Fresh and perishables is all about the freshness and quality of the product.

Tobacco is about price.

Liquor is becoming price driven following the deregulation of the market in Victoria. 5 years ago it was about range and choice. Margins have been reducing due to the competitive pricing strategies of the MSC.

The price of fuel is now a major factor influencing the distance consumers will travel to undertake their supermarket shopping. In country regions, especially those hit by the drought, natural disaster, or falling farm income, distance has become a significant factor.

Consumers are becoming less likely to travel to get their groceries compared to 2-3 years ago.

27. *How do consumers gain information on the pricing of grocery retailers (advertising by grocery retailers, word of mouth, comparisons of key grocery items, etc.)?*

External to the store, pricing information is gained via TV, Handbills, Radio and Press. Word of mouth also has a role to play as does price perception.

The MSC have spent considerable sums on their marketing of 'everyday low prices' or 'price rollback' to create consumer perception of low prices.

Inside the store, point of sale information material communicates price as do the store staff.

Often the product location on the shelf can also indicate price levels eg generic products on the lower shelves.

Questions on the pricing strategies of retailers

28. *What strategies do grocery retailers use to signal their price offers to consumers? What strategies do retailers consider to be the most effective? How do retailers assess the effectiveness of their strategies?*

Most retailers use a combination of TV, press, and handbills.

Woolworths/Safeway uses 'Price Rollbacks'. They increase the back lines over a 4 month period and then reduce the price of selected higher volumes lines. They put millions of dollars behind the rollbacks communications so the perception is of lower prices across the stores. Coles has followed this program.

The MSC have followed international trends funds - higher margins through private labels and shelf positioning.

29. *How do retailers compare their prices with those of other retailers? How often are such comparisons made? Over which products are such price comparisons made? Against which retailers do they compare prices? Are price comparisons done on a national or local basis, or both?*

FoodWorks checks prices each week against the MSC and IGA to ensure reasonable competitiveness and opportunities for strategic advantages.

FoodWorks informs its members of the MSC and IGA pricing but it is the individual retailers that make pricing decisions for their supermarket.

The top 200 lines are compared regularly and a total of 2, 000 lines on a rotational basis over a six week period. Prices are compared nationally.

Generally prices are always compared against Woolworths which is reflective of its dominant market position.

30. *How effective are shopper dockets schemes (such as petrol shopper dockets) in attracting customers? What is the incidence of the use of petrol discount vouchers? How do the supermarket chains fund petrol discounts? Are the discounts funded from higher grocery prices? Is there any evidence of petrol shopper dockets schemes affecting grocery prices?*

In FoodWorks' view, they are now of limited value.

Originally they had an effect however now all retailers have an offer so the MSC advantage has been negated. Nevertheless, retailers who offer an aggressive shopper docket petrol program do attract customers, and do so effectively.

It is not known how they are funded. FoodWorks' members fund the discount out of their store margin. FoodWorks is not aware of any grocery price increases by its members to fund the cost of shopper dockets, the cost comes out of margin or marketing expense. This is seen as a cost of doing business.

The effect of shopper dockets, and hence the impact on individual stores, varies considerably.

C. Competition in grocery retailing

Questions on competition in grocery retailing

31. *Does the nature of competition in grocery retailing differ across products groups? Does the nature of competition differ across the types of shopping trips? What elements of the customer offer are important in each product group?*

Yes, the nature of shopping varies across product groups.

Liquor is highly competitive with declining margins as the MSC build market share.

Tobacco is highly competitive with low margins.

Dry Grocery is price focussed because the products are generally common.

Fresh foods offer a point of difference with quality being the primary determinant.

Generally the 'top up' shop is done through necessity and consumers are prepared to pay a higher price in return for convenience.

32. *Who are the major competitors to the MSC in each of the products groups*

33. *To what degree do Coles and Woolworths compete against each other? To what degree does the option of shopping at other supermarket chains (e.g. IGA) constrain the conduct of the MSC? To what degree does the option of shopping at specialist grocery retailers constrain the conduct of the MSC? To what degree does the option of shopping at convenience stores constrain the conduct of the MSC? How does this differ by product group? How does this depend on the type of shopping trip (i.e. weekly or "top-up")?*

At times, and across a limited range of products, Coles and Woolworths actively compete against each other in the peak selling periods.

At other times it would appear that Coles and Woolworths operate in parallel so that whilst their pricing overall is reasonably comparable, it may not be set by highly competitive forces.

Most back lines are priced by the MSC to derive such margin as the market will bear.

The independents have little or no influence on the MSC prices and do not really compete with the MSC.

The independents have too little market share and are too widespread to provide any competitive force. Where independents are located proximately to the MSC, they must find a particular niche market and track comparable or higher pricing to the MSC to avoid the prospect of being forced out of business through intense competition.

Independents do not have the ability to cross subsidise their profits from other stores and cannot withstand sustained price competition from the MSC.

34. *Has the move by Coles and Woolworths into petrol retailing and the adoption of petrol shopper docket schemes altered competition between the MSC and competition in grocery retailing more broadly? If so how?*

No.

35. *What are the grocery pricing policies of the MSC, and other grocery retailers that operate in more than one location? Do individual supermarket chains set the same product prices across all their stores? If not, are individual product prices determined regionally or store-by-store? How much, if any, pricing discretion is in the hands of the management of individual stores? To what extent, if any, do major national retailers respond at the store or local levels to changes in the grocery prices of local competitors?*

MSC prices are set by a central function. Each store fits a 'pricing zone' based on the competition and the location. Store managers have limited discretion to match competitive prices.

It is thought that the MSC may have as many as 24 different 'pricing zones'.

If new MSC enter an independent's catchment they will price the top selling products below the competition to gain market share. Generally the MSC take 20% market share through this strategy.

Once the independents business become non-viable and closes, the MSC have the ability to put prices up again.

36. *To what degree do grocery prices differ between metropolitan, regional and country areas? How does this differ by product group? What are the major reasons for differences in grocery prices between metropolitan, regional and country areas (transport costs, land costs, market structure and competition, etc.)?*

As previously stated, prices vary in country areas due to increased transport costs and usually due to reduced sales thereby requiring higher margins to cover costs and deliver a sustainable return.

The MSC have the ability to cross subsidize their costs to offer metro prices in the country and will do so from time to time for a variety of strategic reasons.

The independents, without the economies of scale in distribution and without multiple retail stores, are forced to have higher prices or a lower operating margin. Competition in the country is limited.

37. *Is the Australian grocery industry of a sufficient size to sustain a third supermarket chain of similar size to Coles and Woolworths?*

The Australian market desperately needs more competitive access to transparent and efficient supply chains for all players.

The MSC are far too dominant, too large, too powerful, and have too much influence.

If Coles and Woolworths have around 80% of the market between them, it stands to reason that there cannot be another entrant of the same size – there will need to be a degree of rationalisation.

If new players were able to enter, the market share of the MSC would decrease eg Aldi has made significant inroads over a short period. Aldi's market share gains have come from the MSC as it competes with the larger weekly shop rather than the convenience shopping targeted by the independents.

A possible means of increasing competition would be to allow retailers to purchase from any of the wholesale warehouses and for the prices to be regulated to be fair (eg Telstra supplying wholesale services to communications retailers). Regulatory intervention in the industry seems inevitable if real competition is to be resurrected.

38. *What are the key inputs that must be assembled to open a new grocery outlet of a given size?*

Distribution
Sites
Supply agreements.

It will be very difficult for any new entrant to acquire the number and location of required retail sites within a reasonable period of time without taking over existing supermarkets.

39. *Is access to suitable sites a significant impediment to the entry or expansion of supermarket chains? Do local planning and zoning laws impede access to suitable sites? Please provide details.*

Yes. Access to suitable sites having regard to differing State legislation and lead times to develop is complex, costly and time consuming. Purchase of a pre-existing network of stores is a potential possibility.

The new Costco stores only require 5-6 sites per major capital however they need large high access locations akin to Bunnings. It is difficult to see Costco having other than a marginal impact in the overall market.

40. *Are major shopping centre landlords willing to offer sufficient space to a new supermarket chain? Are there any restrictions (contractual or otherwise) that may limit the ability of landlords to offer such space?*

Historically major shopping centre landlords have wanted either Woolworths or Coles as an ‘anchor’ tenant thereby preventing independents from gaining access to the centres.

Usually shopping centre leases contain exclusivity provisions which to a greater or lesser extent ,depending on the negotiating leverage of the parties and the size and location of the centre, will prevent competitive conduct.

It is perceived that the size and variety of Woolworths or Coles together with the drawing power of their names will better attract consumers and other tenants.

FoodWorks is constantly seeking new locations but has failed to gain a site where it has been in a competitive situation with the MSC.

41. *To what degree are smaller supermarket chains discouraged from expanding by higher costs relative to the MSC. What are the sources of higher costs (e.g. higher costs of wholesale groceries, inability to take advantage of economies of scale or density, etc.)?*

Independents have costs at approximately 2% higher than the MSC. These costs derive from the factors specified earlier, predominantly the economies of size, economies of vertical integration and access to warehouses.

These higher costs, and hence the need to make savings wherever possible, including the cost of capital, act as a disincentive to growth and expansion unless the proprietor is able to recoup those higher costs.

D. Competition in grocery wholesaling

Competition in grocery wholesaling

42. *Are there commercial advantages and disadvantages of vertical integration between grocery retailing and wholesaling? What are these advantages and disadvantages?*

The answer depends on your perspective.

For those who are seeking to profit from vertical integration, there is no doubt that there are substantial commercial benefits.

Vertical integration allows control of the flow of products through the supply chain. This means buying scale can be readily pushed out to the retail network.

There are economies in logistics, computer systems, marketing, staffing, cross subsidization and profit shifting, capital for investment.

The disadvantage is that unless there are a sufficient number of vertically integrated chains all competing for limited consumer spends and market share, the consumer loses out. Vertical integration means product control, price control, lack of price transparency, and products not required are continually pushed out of the networks. Suppliers are beholden to the MSC.

For the independent sector, vertical integration has commenced with Metcash acquiring an equity interest in retailers, and having a strategy to acquire interests in fresh food suppliers.

Vertical integration is extremely disadvantageous to independent retailers as it limits supply and competition at the wholesale level and places the control of each retail system in the hands of the wholesaler.

43. *Does the vertically-integration of the MSC impede other players from achieving a competitive scale in grocery wholesaling*

All markets are constrained by their size and growth opportunity. As an example, the Australian population is growing by up to 1.5% annually, therefore the grocery market is self limiting. Hence the MSC have been looking to horizontally integrate their businesses at a wholesale and retail level into petrol, health and beauty, cleaning, and financial services with the potential for pharmacy and newsagency to come.

In doing this, the MSC “mop up” as much available additional value that can be made available to them.

Metcash has a minority corporation's interest (26%) in a number of "independent retail groups" eg Ritchies.

Metcash has also declared its strategy of converting the balance of IGA stores into a 'franchise like' model giving Metcash greater control around the need for a team score approaching 100% (IGA retailer purchases 100% via the warehouse). This model is already being practised in WA.

Metcash has commenced a strategy of acquiring controlling interests in fresh food suppliers to secure supply chains.

As FoodWorks is not owned or controlled by Metcash, FoodWorks does not derive any benefit from Metcash outside of its buying power.

These arrangements prohibit others from entering the wholesale market unless they are multinational chains able to transport proven methodologies into Australia eg Aldi.

The lack of alternative wholesalers would indicate that it may be difficult to achieve and maintain a competitive scale in a country with the physical and demographic challenges of Australia.

44. *Can grocery retailers 'bypass' the large grocery wholesalers? If so, how? Does this vary by the type of product or type of retailer?*

No. Most of the grocery and perishable range must be purchased from the wholesaler's warehouse. There is no viable alternative for the majority of products.

FoodWorks members acquire approximately 58% of their grocery requirements through Metcash with the balance purchased directly with specialty providers of non-warehouse products.

Generally the supply of mainstream Dry Grocery products cannot be by-passed. Some suppliers will endeavour to supply directly to retailers but the economies of doing so on a wide scale deem this unsustainable.

Fresh products ie fruit and vegetables, meat, milk, bakery, due to their perishable nature need to be delivered direct to stores, thereby by-passing the warehouse although of recent times the MSC and Metcash have taken steps to try to have these pass through their warehouse so that they can integrate the supply chain and 'clip the ticket' on the way through.

45. *What are the impediments to entry into grocery wholesaling? Is large-scale entry likely?*

With the present structure in Australia, to be competitive a grocery wholesaler needs to be able to compete with the vertically integrated MSC.

Vertical integration delivers control and control delivers economies:

- Standardisation of operational, commercial and service disciplines
- Centralised control of ranging
- Centralised delivery control
- Single computer systems
- No profit taking at the wholesale level in competition with the retail level

Hence, Aldi as a vertically integrated chain has been able to make a successful but limited entry to Australia.

A new large scale entrant would seem unlikely.

E. Buying power in grocery supply markets

Questions on the buying power of grocery wholesalers and retailers

46. *Are large grocery wholesalers or retailers able to acquire products from suppliers at lower prices or on better terms than smaller wholesalers or retailers? Does this differ by product type?*

Absolutely.

We believe the MSC have something like a 2% better buying advantage over Metcash which in turn has a significant buying advantage over FoodWorks.

The MSC and Metcash have turned buying terms into something of an artform to the point where it is virtually impossible to determine the actual cost price.

Generally terms are confidential, however the transcript of evidence in the matter of *Franklins Pty Ltd v Metcash Trading Ltd [2007] NSWSC 242* provides some guidance on the range of terms, deals, rebates, commissions, discounts and other benefits operating in the industry and also the level of confusion and obfuscation in the use and application of those terms.

47. *Do grocery wholesalers or retailers with buying power pass on the lower prices they can achieve from suppliers to retailers and consumers?*

The profit performances of the MSC and Metcash would suggest, notwithstanding their statements to the contrary, that the lower prices and economies in supply chain management are not being passed on.

48. *Do suppliers incur lower unit costs in supplying larger wholesalers or retailers? What are the sources of these costs savings (bulk sales, purchase guarantees, etc.)? Are these reflected at the retail level?*

Yes. We estimate something like 2% lower. Cost savings derive through scale, reduced logistics costs, and retailer compliance with stocking and marketing. Wholesalers have a number of trading terms to reflect the various advantages and economies of scale.

There may be, but is not necessarily, a direct correlation between the buy price to wholesalers and sell price to retailers. In the case of the MSC, this is simply a matter of determining where it wants to record their internal profits – it makes no overall difference to the profitability of the corporation.

In the case of Metcash, it does seek to maximise its profit at the wholesale level and hence it will sell to retailers at the most advantageous price it can achieve. In this regard, Metcash competes with retailers to maximise margin.

49. *Do suppliers offer the same terms and conditions to all grocery wholesalers or retailers? For example, if a small wholesaler offered to purchase the same volume as a large wholesaler, would the small wholesaler receive the same volume discount?*

No.

50. *Is there evidence that large grocery wholesalers have market power as acquirers of products and what are its effects at the retail level?*

Anecdotally suppliers claim that the large wholesalers have, certainly in the past, sought to 'pay less and demand more' through a variety of trading terms however FoodWorks has no direct evidence.

51. *Do slotting fees (fees paid by manufacturers or producers to have their products placed on supermarket shelves) reflect the existence of market power? What is the extent of slotting fees? How do slotting fees affect the competitive dynamic between producers/suppliers and the level of barriers to entry for producers/suppliers? How does the ability of supermarkets to control shelf placement and in-store promotional offers affect the competitive dynamic?*

It is generally understood that unless a supplier pays the slotting fee (by whatever name that might be given) to the MSC, the products do not get on the shelf. FoodWorks does not have ranging fees.

This generally means the larger suppliers get 'ranged' as they have the better ability to pay. This leads to less competition at supplier level as smaller players disappear.

Most retailers will seek to utilise their shelf space and gondola ends to secure a range of promotional fees from suppliers at various times through the year (eg Easter eggs) however this is different to whether the products are ranged at all.

52. *Are there other forms of behaviour or conduct by supermarkets in their dealings with producers or suppliers that may indicate market power?*

Farm gate sourcing by the MSC has the effect of controlling the price of produce, whereas previously the wholesale produce markets determined the prices.

By reducing the amount purchased at the markets to about 20% of volume, the MSC can dictate the price they will buy produce from the farm gate. Farmers have little choice but to take the prices being offered. This leads to the smaller producer being less viable, which leads to fewer producers and less competitive price pressure.

Market power is exercised by the wholesalers.

Retailers are either part of chains, not owned but controlled by the wholesaler (eg IGA stores) or are independent and price takers rather than price makers (FoodWorks).

53. *How could grocery wholesalers or retailers exercise any market power? Could major retailers credibly threaten to 'delist' a product or brand? How would consumers react if their desired brands are not available at their local supermarket? How important is the potential for a grocery retailer to substitute to a private-label or generic brand? Do major retailers threaten to import products in preference to local brands and how credible is the threat? What options do suppliers have if this occurs? Where else could suppliers sell their products (other grocery retailers, exports)? What are the consequences at the retail level?*

As stated above, the major retailers are owned and controlled by the wholesalers and it is the conduct of the wholesalers that requires examination. Retailers per se do not exercise market power.

If a desired brand is not available, it is likely the consumer will search for the product in another retailer. If the substitute is at a value that outweighs the cost of shopping elsewhere they will readily buy the substitute.

The MSC are rapidly substituting proprietary brands with Private Label products. This generally leads to fewer suppliers as the majority of food items are imported. The Private Label product has no direct competitive product as they are exclusive to the retailer. This means there is no need to offer price reductions as might be the case for a branded product that is readily available in all retailers. In addition the MSC gain the supplier margin as well as the higher retail margin.

F. Competitive position of small and independent grocery retailers

Competitive position of small and independent grocery retailers

54. *What are the major sources of competitive advantage and disadvantage of small and independent retailers (e.g. trading hours, scale of operations, density of retail outlets, location of retail outlets, wholesale prices, product and brand range, customer service, etc.)?*

FoodWorks' competitive advantage is primarily in its neighbourhood/local store locations.

FoodWorks' customers desire the convenience of local shopping and require a comprehensive, but not excessive, range of products.

In rural and provincial locations, there is a shift in buying behaviour to local shopping. With FoodWorks, the owner of the store is in the store. Being closer to the customer means the retail offer can be more relevant. Prices can be adjusted by the storeowner to reflect immediate requirements. FoodWorks exists to serve its customers.

FoodWorks cannot compete on range and cannot sustain price competition. FoodWorks' members do not have a number of stores to subsidize competitive behaviour. FoodWorks does not have the advantages of vertical integration. FoodWorks can only source dry groceries from one warehouse.

As FoodWorks' sales and share of market are increasing, we can only conclude that our competitive advantages appeal to customers.

55. *To what degree do differences in wholesale prices and other wholesale terms and conditions undermine or otherwise affect the competitive position of small and independent retailers?*

Metcash provides the same 'strip net costs' to FoodWorks as it does to its vertically integrated or independent IGA stores. FoodWorks is unable to negotiate better terms as there are no competitive forces.

What does differ is the level of support provided by the wholesaler in the form of marketing subsidies and additional deals that IGA stores receive but which FoodWorks stores do not.

56. *Are the wholesale prices independent and small retailers pay affected by the wholesale prices the MSC pay? For instance, if a MSC puts pressure on a supplier to lower its prices will the supplier:*

- *attempt to 'make this up' by charging more to other wholesalers and retailers, or*
- *reduce the prices it charges other wholesalers and retailers so other wholesalers and retailers can remain competitive with the MSC?*

It has often been said that pricing between suppliers and wholesalers involves 'smoke and mirrors' so that the true price is really only known to the parties involved.

Whilst the invoice price may be the same, there are a range of published and confidential terms which greatly impact the actual net price. The retailer has no visibility of the actual net price to the wholesaler.

FoodWorks has no evidence to suggest that suppliers reduce their prices across the board to provide equal competition. It is thought that suppliers will seek to achieve the best price they can.

57. *Please provide any estimates of the differences in wholesale costs faced by small and independent retailers relative to the MSC?*

FoodWorks' estimate is that the difference is in the order of 2% but we have no way of knowing the actual differential.

In a high volume low margin industry, 2% is a substantial disadvantage.

"This is a volume game. We will absolutely go to war for a quarter of a per cent margin. That's life or death for us."

Mr Andrew Reitzer, CEO, Metcash, AIM Management Today April 2005

Shopper docket schemes

58. *What impact have petrol shopper docket schemes had on small and independent grocery retailers? If shopper dockets are not offered, does this affect the ability to compete with the MSC?*

This begs the question of whether in fact independent retailers actually compete with the MSC or rather

- operate where the MSC do not; or

- provide a reasonably comparable but not really aggressively competitive offer?

In a directly competitive situation, there is little doubt that the MSC have the size and resources to destroy smaller retailers. There have been numerous examples over the years of what we would maintain have been predatory tactics to force smaller retailers out of business or to sell out.

Hence smaller retailers operate away from the MSC or, where they are proximate, focus on convenience and other factors rather than trying to compete on price to win market share.

In either of these scenarios, shopper dockets do not really impact the ability to compete.

The new Woolworths petrol card will probably make it easier to use so they will build increased loyalty with their existing customers but it is unlikely to detrimentally impact smaller retailers.

Shopper dockets are designed to allow the MSC to benefit from more of the consumer spend (ie grow the size of the pie) rather than take market share.

No doubt the MSC will seek to expand into other areas (eg pharmacies, newsagents, post offices, banks, etc) as a means of aggregating the consumer spend through their stores.

59. *Have independent grocery retailers attempted to implement their own petrol discount schemes or other discount schemes? What has been the success of those schemes?*

FoodWorks has used a reverse docket system.

“Bring in any petrol docket, spend over $30, and you receive 4 cents a litre discount off your groceries.”

The aim is to negate the MSC offer and make every petrol station available to the customer base.

The amount of redemption has been limited and has not been considered a traffic driver unless the offer is at a higher discount level or tied into other promotions.

Mergers and acquisitions in grocery retailing

60. *Have there been acquisitions of independent stores by the MSC in the past three years that have not been brought to the ACCC's attention and are not listed in Attachment A?*

A significant number of large independent stores have been purchased by the MSC by creeping acquisition.

From FoodWorks' perspective, the greater threat has been the ability of Metcash to convert existing FoodWorks' stores to IGA stores.

Each loss of a supermarket to FoodWorks reduces volume and hence market competitivity.

61. *What has been the effect of acquisitions, particularly combinations of acquisitions, on the competitiveness of independent wholesalers and retailers?*

Acquisitions by the MSC has lead to a decline in market share of the independent stores, however in the past few year the Independents have been able to sustain their current market shares.

The independent wholesaler, Metcash, has itself become acquisitive to mirror and compete with the MSC.

Metcash has strongly built buying power since the FAL takeover and along with the repositioning of FoodWorks has commenced a resurgence of the independents in the Australian market. This is in its early days, reflected in market share growth, and must be maintained to ensure the MSC don't assume 90+% of the marketplace.

62. *In particular, have the relative costs of independent wholesalers been affected by recent merger activity in supermarkets? If possible, please provide evidence. Have prices paid by independent wholesalers and retailers to suppliers or terms of trade with suppliers been adversely affected? If possible, please provide evidence. Have there been flow-on effects to independent grocery retailers?*

The recent FAL acquisition by Metcash should have been reflected in greater efficiencies gained by the larger volumes.

> ***" We are pleased to announce that the 2007 financial year was another successful one for Metcash and the eighth consecutive record annual profit has been posted."***
>
> Metcash Trading Limited 2007 Annual Report

None of the published gains have translated to lower prices, lower service fees, or better service levels. There has been no flow of benefits to FoodWorks.

Conduct of grocery retailers

63. *Is there evidence of any anti-competitive conduct in grocery retailing? What types of market conduct are of most concern to grocery retailers and wholesalers?*

FoodWorks has previously brought to the attention of the ACCC allegations of predatory pricing by the MSC where we have claimed that the purpose of the conduct has been to force an independent retailer out of business or to sell to a MSC.

Under the legislation that existed at the time, no action was taken by the ACCC and indeed FoodWorks was of the distinct impression that the ACCC thought that the short term gains through lower pricing were "good for consumers". The ACCC did not seem to be interested in the argument that in the longer term prices would increase above competitive levels. This attitude may have been impacted by the *Boral* decision.

FoodWorks is not aware of any anti-competitive conduct that might compromise price competitiveness at the retail level.

64. *Is there any evidence of predatory pricing by larger retailers and wholesalers, and if so, is there any evidence of any adverse impact on independent/smaller retailers and wholesalers?*

Now that the retail sector has been substantially rationalised, there is no longer the need for sustained predatory conduct to achieve market dominance.

Occasionally the MSC are able to sell at prices below the independents' cost prices, particularly in liquor, but these are short term strategic measures, which, whilst they hurt the independent retailers and may cause compensatory price rises, are perceived to benefit consumers.

65. *Please describe any such conduct (including specific instances) and the effect of the conduct on competition in grocery retailing*

The possible predatory pricing behaviour by the MSC with the VB product from Fosters is an example of the market power they have.

By continually selling 10% below cost they may be offering lower prices however they are putting the smaller players out of business. You can only match these below cost prices for so long.

An added effect is the "channel swapping" that is occurring because Woolworths sell VB lower than Fosters can supply FoodWorks.

15% of the volume is now through our direct competitor. This is a deliberate distortion of the competitive market. The loss of volume through channel swapping translates to direct loss of buying power to FoodWorks - our retailers buy from the MSC retail stores and resell to our customers. This makes FoodWorks less viable.

In other words, where FoodWorks buys through the wholesaler, FoodWorks derives financial benefits related to the volume of purchases. By moving to purchase from its retail competitor at prices below what it can buy from the wholesaler, FoodWorks loses those benefits.

So the retailers lose out by not being able to match the below cost pricing and the FoodWorks group lose out through loss of trading term income due to "channel swapping".

G. Factors influencing the pricing of inputs along the supply chain for standard grocery items

Questions for suppliers of grocery products

66. *What are the major influences on the prices you receive for your produce? How are your prices determined? What proportion of the retail price of the product do you receive?*

67. *Have the prices you receive for your produce changed over the past 1 to 3 years? What have been the major reasons for any changes in the prices you receive? Have your costs of production changed over the past 1 to 3 years? Have the prices you receive for your produce changed by more or less than your cost of production? Please provide details?*

68. *To whom do you sell your produce? What supply arrangements do you have with the buyers of your produce? Do you sell any of your produce to the MSC? If so, what options do you have if you decided not to sell to the MSC (other grocery retailers or wholesalers, food processors, exports, etc?)*

69. *If a MSC put pressure on you to lower your prices would you attempt to 'make this up' by charging more to other wholesalers and retailers, or would you also lower your prices to other wholesalers and retailers so they can remain competitive in grocery wholesaling and retailing?*

Questions for wholesalers and retailers of grocery products

70. *Do changes in retail grocery prices reflect changes in the prices you pay your suppliers? For example, do retail grocery prices reflect changes in farm gate prices? Please provide details.*

Price changes that result from cost increases by suppliers are generally reflected immediately in the retailer sell price.

However the exception is whether or not the MSC have the same cost increase and take the same actions. If MSC hold prices down then FoodWorks will attempt to match this until it is no longer affordable and the retail margins cannot sustain the lower price.

Alternative products will be sourced or products increased in other areas to compensate for the margin loss. FoodWorks does not set the market price.

71. *Do cost savings in the supply chain flow through to lower retail prices for consumers?*

FoodWorks is not aware of any savings in the supply chain that have flowed through to lower prices. Indeed, Metcash has reported increased profits due to supply chain savings:

> ***"The margin growth was aided by well controlled costs with the Cost of Doing Business (CODB) as a percentage of gross profit falling by 0.34% to 66.86%. As a consequence, normalised Profit Before Tax (PBT) as a percentage of sales rose 0.30% to 2.62%. The higher sales volume accompanied by the higher margin ratio resulted in the improved earnings per share and dividends paid and declared for the year"***
>
> Metcash Trading Limited 2007 Annual Report

Any reduction in costs by FoodWorks over the last two years have been due to negotiating better costs by the FoodWorks' Merchandise team outside of supplier inputs.

72. *What is the nature of the supply arrangements you have with suppliers? How are prices determined under these arrangements*

FoodWorks has entered into a confidential supply agreement with Metcash for the provision of dry groceries, packaged liquor, tobacco and perishables.

FoodWorks has a range of direct supply arrangements with suppliers of products other than dry groceries, again the terms of which are commercial in confidence. Prices are negotiated and usually have volumetric breaks.

There is no direct relationship between the prices under supply agreements and the retail prices (ie retail prices are not set on a cost plus % basis).

Retailers determine the level of margin they need to achieve above a base price to make their business's profitable in their location.

H. Impediments to efficient pricing of inputs along the supply chain

Impediments to efficient pricing of inputs along the supply chain

73. *Is there evidence of market power in the supply of grocery products to retailers or wholesalers? Please identify specifically which grocery products and explain the sources of market power?*

74. *Are there any impediments to cost savings flowing through the supply chain to consumers?*

75. *What are the consequences for suppliers of any market power of grocery wholesalers or retailers in the acquisition of grocery products (e.g. lower prices to suppliers, transfer of risk and/or costs to suppliers, decreased incentive for investment and innovation along the grocery supply chain, etc.)?*

76. *What are the potential consequences of suppliers having any market power along the grocery supply chain?*

77. *Has the degree of vertical integration in the supply chain had an effect on the pricing of inputs? If so, in what way?*

78. *What impact, if any, does the presence of direct supply agreements have on the level of competition in the markets for those individual products?*

Direct supply agreements (ie other than through the wholesale warehouse) for certain specific products eliminate costs from the supply chain and allow the retailers to be reasonably competitive. For example, purchase of bakery products from a local supplier.

Perishable products lend themselves to direct supply agreements.

The cost of distribution across the retail network is usually prohibitive for direct supply arrangements to be able to compete with the major distribution centres.

79. *How has the sale of private-label or generic products by grocery retailers changed in recent times? Has this change had any impact on the level of competition along the grocery supply chain?*

The % of Private Label to sales has increased dramatically over the last two years.

Coles is targeting 30% of sales and Woolworths is targeting 25%. Aldi is 100%. FoodWorks is targeting 10%.

Increased Private Label lowers the level of price competition. Private Label products are exclusive to the retailer. They no longer need to discount the national proprietary brand which is available in all stores if there is an equivalent Private Label product.

In addition, Private Label products displace the secondary or tertiary brand from the shelf leading to a lessening of suppliers competing for shelf space.

80. *Do the pricing arrangements, terms and conditions of supply, or contracts between suppliers and wholesalers/retailers limit the degree to which suppliers can pass on cost savings or cost increases?*