MASTER
GROCERS
AUSTRALIA

# Submission by Master Grocers Australia to the Australian Competition and Consumer Commission Inquiry "into the competitiveness of retail prices for standard groceries."

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## Introduction

Master Grocers Australia (MGA) is a National Employer Industry Association representing Independent Grocery and Liquor Supermarkets in Victoria, New South Wales, ACT, Western Australia and Tasmania. These supermarkets trade under brand names such as IGA and FoodWorks and range in size from small, to medium and large businesses.

Independent supermarkets play a major role in the retail industry and make a substantial contribution to the communities in which they trade. There are 2,100 independently owned IGA and Foodworks supermarkets in Australia, employing over 70,000 full time, part time and casual staff and accounting for around $12 billion in retail sales. Many MGA members are small family businesses, employing 25 or fewer staff.

MGA, on behalf of its members, welcomes the opportunity to make comment, by way of submission, to the Australian Competition and Consumer Commission Inquiry "into the competitiveness of retail prices for standard groceries."

*MGA's submission mainly focuses on the competitiveness of the grocery industry, the competitive position of independent supermarkets, and the structure of the grocery market. We have endeavoured to also highlight aspects of the current regulatory regime which are inadequate to sufficiently protect competition in this industry. We believe that vigorous competition is the best means for delivering optimal prices to consumers,* and that a central aspect *of a grocery prices inquiry must also consider the state of competition in the market.*

Over the past 15 years MGA retailer members have witnessed substantial changes to the supermarket landscape grossly affecting the breadth of choice and competition for the Australian consumer. The two major chain retailers, Woolworths and Coles, have been allowed to grow their businesses to an unprecedented dominant 80% market share of the retail grocery market. While a proportion of this growth has been a result of excellent competitive performance, some of it has developed due to a lack of restraint on certain anticompetitive advantages that thrive in a concentrated market. Dominance of such magnitude is to be found nowhere else in the developed world and has been allowed to continue despite various unsuccessful regulatory attempts at constraint. This situation continues despite the increasingly apparent medium to long term detrimental effects on small business. These detrimental effects, in particular a drastic reduction in competition within the grocery market, will acutely impact the consumer.

The role of independent supermarkets in Australia is unique. Independent supermarkets around Australia strive to operate with a strong sense of community, economic sustainability and in an environmentally friendly manner. Independent supermarkets actively work within their local communities. They will only operate in local communities when there is demand for a supermarket. Independent supermarkets are built at a size suitable for the local community. They operate in the main shopping precinct or existing strip shopping area to sustain and work with existing local businesses. Independent supermarket operators support environmentally and economically sustainable practice through stocking local produce and locally sourced products in their supermarkets.

In addition to the community role that independent supermarkets play, they provide a vital competitive force in the Australian grocery industry. They have proven that they can compete on price, and should have a robust future as a third force in grocery retailing. The major risk to the vitality of independent supermarkets and their advantageous competitive influence is the continual growth of the major chains, where such growth is attributed not to greater efficiencies and better consumer product offers, but anticompetitive behaviour stemming from enormous market power. Additional regulation of such highly concentrated industries is vital to ensure that competition is not eliminated through use of market power, under the guise of greater efficiency.

## The grocery industry

The grocery industry in Australia is widely acknowledged as being unique for its high degree of concentration. Nationally, it has been estimated that around 80% of market share is held by two market participants, Coles and Woolworths. The rest of the market is divided between various independent supermarkets. Market share has been measured by grocery sales amongst supermarkets. MGA considers this to be the most appropriate way to measure market share.

The major chains generally dispute this method of attributing market share. They argue that they operate as part of a general food retailing industry, which includes takeaway food, restaurants, liquor and fuel. Calculated on this basis, the market share of the major chains is significantly lower. MGA does not agree with this approach. Definition of the market cannot be an isolated exercise, but must rather be undertaken with an understanding of why we seek to define the market. There is a need to understand the competitiveness of supermarkets in grocery retailing, and therefore to establish the competitors within this arena. It is too vague to declare supermarkets as part of a generic “food retailing” category, as market definition centres on close substitution and such a wide market definition does not give any insight into competitive constraints operative within the grocery market.

Understandably, when examining the grocery industry, there are an enormous range of factors to consider, including the wide variety of product categories and the range of consumer needs and desires that a grocery retailer might need to fulfil. While geographically, the market might be more precisely and narrowly defined, on the product level, it is almost impossible to neatly and succinctly delineate a clear market.

Product substitution offers a helpful means of defining the boundaries of the grocery market. This theory evidences the shortcomings of including take away food, restaurants and liquor as competitors for grocery retailing. The accepted approach to market definition is embodied in a price-sensitivity test, which focuses on consumer behaviour in response to a small but significant non-transitory price increase (SSNIP test)[1].If the major supermarket chains increased the prices of their headline groceries by 5%, the effect on a majority of consumers must be considered. It is likely that consumers will move to independent supermarkets or minor chains for their bulk shopping trips. It is unlikely that these consumers will move en masse to restaurants and take away stores in substitution for grocery outlets. They may feasibly shop more at specialty shops such as bakeries, delicatessens and butchers shops for particular items. These are best categorised as sub-markets for our purposes, and can be understood as having a fringe competitive effect. However, it must be noted that the main price constraint on the large chains remains independent supermarkets. The main competition for the major chain supermarkets, therefore, clearly comes from other supermarkets. Some competition may also come from convenience stores, depending on the type of shopping trip sought by the customer.

It is therefore reasonable to describe the market for our purposes as being for supermarket packaged groceries, although some competitors in certain submarkets will not be supermarkets. In such a market, Coles and Woolworths between them clearly have a dominant market share. While market share is not the sole indicator of a monopoly, or in this case duopoly, it is a significant factor. MGA submits that the large chain stores have significant market power which, as discussed later, may allow them to engage in anticompetitive behaviour. It is essential to note that MGA does not advocate for special laws to protect small businesses against vigorous competition, nor for any competition laws to regulate the grocery industry itself. Rather, we assert that competition must be fair, and the nature of such a highly concentrated market provides greater potential for anticompetitive behaviour, which can have more severe effects on competition and consumer welfare.

## Changes to the structure of the market

The structure of the market for grocery retail and wholesale has undergone significant change over the last few decades. Since the 1970s, Coles and Woolworths have grown their market share phenomenally. The major chains were in part able to gain their current market share through attaining efficiencies; particularly utilising economies of scale and vertical integration to achieve cost

[1] Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd (1976) 25 FLR 169

savings and lower unit prices. Both businesses have vertically integrated their wholesale and retail functions. This allows for significant savings in many areas including centralised warehousing, stock control, stock turnover and volume, refrigeration and freight. It also allowed for significant negotiating power on overheads such as rent and insurance. These cost benefits provide a flow-on competitive advantage, allowing savings at the wholesale level to be passed on to retail consumers.

Independent grocery retailers did not remain static in the face of such changes. Realising that they needed the ability to match Coles and Woolworths in terms of efficiency, structural change was also to follow. Independent supermarkets found that they needed to work together to achieve similar economies of scope and scale to the chains, and therefore remain competitive in the market. The many varied independent retail brands consolidated. For instance, in Victoria in the 1990s there were 10 retail brands. Now there are 2 retail brands: FoodWorks and IGA. This has strengthened the competitiveness of independent supermarkets as a “third force” in grocery retailing.

There was also structural change at the wholesale level, in order to compete efficiently with the vertically integrated chain stores. Prior to this development, independent retailers had been utilising a variety of wholesalers. The efficiency of the chain stores’ integrated functional levels made such a position untenable. Competition amongst wholesalers was reduced as they fought for an increasingly diminishing market share. This resulted in the emergence of a single independent wholesaler, Metcash. Metcash were then competing in the wholesale market with the wholesale divisions of Coles and Woolworths. Although Metcash operates as a separate wholesale business, they have the capability, infrastructure and demand to achieve the same economies as the vertically integrated wholesalers, which they do. The independent brands do not often exclusively gain supply from Metcash, but many of them receive the bulk of their goods in this manner. The reduction in competitors operating in the wholesale market was generally considered to have had a pro-competitive effect, due largely to the savings and efficiency that could be secured by the streamlining of the retail and wholesale function and passed on to the consumer.

Currently, the chain stores and a unified independent supermarket industry offer significant benefits to consumers. Businesses with large economies of scale afford opportunities to increase efficiencies and reduce costs for consumers. These businesses can obtain real benefits when sourcing for the retail market. These benefits can then be passed on to consumers. With respect to the major chain stores, large economies of scale can be particularly beneficial in regional settings which have traditionally been associated with higher grocery costs due largely to additional freight expenses. An efficient grocery network which covers both regional and more central areas is able to spread its costs across the entire business and thereby reduce the effect on grocery prices in regional areas.

The consolidation of the banner groups and the position of Metcash allows independent grocery retailers access to benefits derived from similar economies of scale and bargaining powers as the major chains, theoretically putting them in an equally competitive position. However, MGA submits that the rapid increase of the chain stores, to the detriment of independent retailers, is in part caused by anticompetitive advantages gained through substantial market power. The effect of this is a decrease in actual retail competition in the grocery industry, as independent stores remain the only true check on the ability of the major chains to increase prices at will.

## Effect on competition in the Grocery industry

Australian law and policy, as in many other jurisdictions, encourages a robust competitive market. Competition is assumed to increase efficiency, through economies of scope and scale, innovation and resource allocation. This in turn benefits the consumer, through greater choice, better products and lower prices. The aim is not to protect competition for competition's sake, but to protect competition precisely because of the economic benefits that we assume it delivers to consumers. Competition in concentrated markets such as the grocery industry in Australia has some particular regulatory difficulties.

The main point of concern for present purposes is that current pricing of supermarket groceries may indicate that the market is not operating at an optimal competitive level; a concern that has been raised many times.

### *Price competition*

Both the chain stores and the independent supermarkets closely monitor each other's prices. It is absolutely necessary for independent supermarkets to be extremely competitive on prices, and to ensure that they are offering excellent product promotions. Individual store owners offer a uniquely immediate sense of competition in the retail industry. Store owners can quickly react to competition, and have a high level of discretion. When a chain discounts a product, an independent can rapidly and decisively provide an alternative offer on that product.

To an extent, the major chains compete against each other and there is some limited safeguard there. However, given the availability and transparency of pricing in stores, each major chain can easily monitor the prices set by the other. This significantly increases the potential for market sharing behaviour, by which the major chains do not need to compete on price, but can maintain the same prices in the knowledge that they control the market. The actual extent of vigorous price competition between Coles and Woolworths is unclear, but the existence of a conspicuous duopoly combined with easy access to each other's prices makes market sharing a real threat, even in the absence of any agreement to that effect. What is clear, is that the presence of a strong independent competitive force can be effective to work against the potential for collusive behaviour and anticompetitive parallel pricing.

The current market divisions also give rise to predatory pricing concerns. There are always certain difficulties with distinguishing between anti-competitive pricing, aimed at eliminating competitors or raising barriers to entry, and competitive pricing designed to benefit the consumer and legitimately compete in the market. The major chains' position allows them to largely dictate prices, and in particular, to discount headline products to attract customers.

Below cost pricing does not make economic sense unless the entity employing the strategy considers that they will recoup their losses at some stage. This leads to the likelihood that the discount is compensated by raising the price of non-headline products. One consequence of this is that the industry may become very competitive on these headline products, while a large range of secondary products are artificially inflated to compensate, thus distorting the true price of many groceries and leaving the consumer unable to make informed choices in this regard. Another, more insidious effect of below cost pricing may be that a store that has the capacity to sustain such a pricing policy may have a long term strategy for recouping their losses – by driving their competitors out of the market. A business with large resources can feasibly fund sustained losses in an isolated geographic market with a long term view to dominance, and increased profitability in that market. This poses a particular risk to regional independent stores, who can often match prices with the major chains in every respect, but cannot sustain the sort of losses that below cost price competition inflicts. Such pricing behaviour can then act as a strategic barrier to entry, deterring potential new competitors.[2]

The provisions of section 46 of the Trade Practices Act dealing with misuse of market power are meant to deal with circumstances of predatory pricing. There have been significant problems in the application of this section to instances of alleged predatory pricing. The legislation would be of more assistance with specific reference to predatory pricing, particularly firmer guidelines as to how to distinguish competitive pricing from predatory pricing, and how to view below cost pricing in this respect. It might be appropriate to assume that below cost pricing is predatory and shift the burden of proof once it is established that a company with market power is engaging in below cost pricing.

### *Price discrimination*

While vertical integration in the major chains may allow for greater efficiencies and savings, there is some reasonable concern about the massive bargaining power that this gives them against suppliers. This is especially the case where a business operates at more than one functional level, as there is potential for

[2] Boral Besser Masonry Ltd v ACCC [2003] HCA 5.

power in the retail market to be exerted in the upstream wholesale market. While competition amongst the major wholesalers (Coles, Woolworths and Metcash) may be robust, it is likely that the dominant position of Coles and Woolworths in the retail market gives their integrated wholesalers an increased level of demand side market power, which results in advantageous supply prices that have nothing to do with economies of scale. Given their retail market power and their immense buying power, there is potential for the chains to exert anticompetitive pressure on suppliers to achieve lower prices. Suppliers who want to maintain strong business relationships with extremely powerful retailers are faced with few alternatives but to appease the major chains. Independents, with significantly less market share at the retail level, may have less bargaining power and are less well placed to demand the benefits the chains may receive, even if all other considerations, such as volume, are equal.

As suppliers respond to pressure from the chains by lowering costs, they may need to account for lost revenue elsewhere. Where the chains place pressure on suppliers to reduce costs and heighten price competition, the effect may drive up supply costs for independents. The risk, therefore, is that a duopoly with the sort of market share held by Coles and Woolworths, which is apparently seeking better prices from suppliers, may actually decrease the ability of independents to compete fairly and thereby reduce the competitiveness of the industry. Right at the beginning of the supply chain, there is significant potential for the major chains to use their market power to gain an unfair advantage that can never be made up by the smaller competitors and can result in driving competitors out of the market. To this end, greater transparency in pricing by suppliers would assist to prevent suppliers recouping from independents losses created by the chains.

The practice of price discrimination can have both anti-competitive and pro-competitive effects. The pro-competitive effects were central to the recommendation by the Hilmer report that section 49 of the Trades Practices Act be repealed, and the subsequent removal of this section from the Act. The issue is one of price flexibility. Outright prohibitions on price discrimination limit the pro-competitive aspect of suppliers being able to offer lower prices to compete at the supply level. However, price discrimination remains a significant problem in the grocery industry. MGA accepts that competition law cannot address specific industries. However, it can seek to address problems that arise in specific market structures. The grocery market, as previously discussed, is highly concentrated. In such a market, the consequences of price discrimination are more likely to have an anti-competitive effect.

There is some scope for anti-competitive price discrimination to be addressed under section 46 of the Trades Practices Act. A company will be in breach of s46 if it has market power and takes advantage of its market power for various anticompetitive purposes. This can certainly encompass price discrimination, however the purpose test has been widely acknowledged to be a significant barrier to enforcement of this section, and demands a high burden of proof.

There has been some debate around the merits of an effects test to alleviate the burden of the purpose test. MGA is in favour of an effects test, however we also hold that the specific inclusion of a prohibition on price discrimination in Part IV of the Act is desirable. MGA would like to see the re-introduction of a legislative prohibition on price discrimination, with a threshold market concentration test. In such a concentrated market then, when the potential damage done by price discrimination is so severe, instances of price discrimination could be examined on a case by case basis to evaluate whether it is pro-competitive or anti-competitive. Otherwise, the unchecked effects on businesses with a smaller market share can be devastating, and result in the elimination of efficient competition and the establishment of entrenched market dominations.

## Increased market concentration

The market dominance of the major chain stores is increasing, not because independent retailers cannot compete economically, but because of the anticompetitive elements of the market structure, and the conduct that it allows. Despite the pressures exerted by the chains, the independent grocery sector is well positioned to provide real competition to the chains in the wholesale market. Independents often source products locally. This works to lower freight and warehousing costs. It also reduces the rate of spoilage resulting from injury to produce during transportation. This decreases the loss suffered by store owners and, in turn, reduces that costs that are transmitted to consumers. Local sourcing delivers to consumers fresher, more saleable produce. This provides incentives for the chain stores operating in competition with independent grocers to deliver to customers higher quality, fresher products. Locally produced products also engender loyalty from consumers choosing to support local industry. In sourcing local produce, independents occupy a unique segment of the grocery market and provide much needed competition to the chains.

The Australian grocery industry is unique. It differs significantly different from its European and North American counterparts which sustain a considerably larger array of chains in competition with each other. While competition is paramount to ensuring the vitality and dynamism of the industry, the Australian grocery market is unlikely to be benefited by the introduction of a third large supermarket chain. Such an introduction may in the short term increase competition by dividing the market between four main groups. However, a new chain would capture parts of the existing market from both the chains and the independent grocers. In the long term, decreased independent market share would reduce the independents' effectiveness as a constraint on the chains. In effect, the emergence of a third chain would replace some independent market share and so would shift the application of competitive pressure from independents to the new chain. The emergence of a new chain is unlikely, in the current Australian market, to inject more competition into the industry.

It is important to consider the means by which the major chains are able to increase their market share so consistently. The Trade Practices Act generally prevents mergers and acquisitions which have the effect or likely effect of substantially lessening competition. However, these provisions are not effective against "creeping acquisitions", where one single acquisition may not have the effect or likely effect of substantially lessening competition, but the long term effect of these acquisitions is to increase market power by the major retailers. By acquiring more and more competing businesses, the major chains are able to slowly grow their market share while escaping the scrutiny they would be subject to had they increased their market share in a single large acquisition.

It should be noted that increased regulation of creeping acquisitions may sometimes have a negative effect, albeit limited, on independent supermarkets. Restricting the ways in which the major chains can appropriate individual independent stores could decrease the potential exit pathways for independent supermarket owners wishing to sell their businesses. Indeed, increased regulation of creeping acquisitions acts to limit the growth of the chains market share rather than stimulate the introduction of new independent stores to the market place. Nonetheless tighter regulation of creeping acquisitions will curtail the capture of independent stores by the major chains, and it is this expansion strategy by the chains that signifies a real threat to competition within the retail grocery market.

Even when minor acquisitions can be examined by the ACCC, there are still limitations on how they may view and deal with the cumulative effect of many minor acquisitions, which as a whole may have a significantly detrimental effect on competition. Particularly in a highly concentrated market, many instances of single store acquisitions have an overall effect that is highly undesirable in a competitive market. MGA considers that when there is a particularly high level of concentration in a market, it should be provided that all further acquisitions by dominant entities must be reviewed in terms of its competitive effect on the market. It is not appropriate for the issue of creeping acquisitions to be ignored any further.

The major chains are also able to increase their market share through the unfair bargaining position that their market dominance affords them in terms of access to high quality retail sites. Independent stores have traditionally been perceived by developers and investors as lacking the level of customer attraction that the chains posses. They are often viewed as unable to rival the chains in generating shopper traffic and are less able stimulate shopping behaviour. Accordingly, independent supermarkets are not as highly sought after by developers and investors who view Coles and Woolworths as powerful anchors in providing their shopping precincts with the greatest shopper yield possible. While this in itself is really a measure of the chain stores' success, their ability to centrally negotiate on costs such as rent further compounds the difficulties independents have in obtaining good quality retail sites. With greater market power and a vertically integrated business, a chain is well positioned to negotiate more favourable rates from developers. Lacking the chains' reputation for generating customer yield as well as the chains' capacity to negotiate well on rent, independent supermarkets seeking to move into strong shopping precincts find themselves burdened with higher costs. In this sense, independent supermarket operators are discouraged from expanding their businesses by higher costs relative to the chains. It operates as an effective barrier to entry, further consolidating the chains' market power and allowing their increasing market share to go unchecked yet again.

A further barrier to entry for independent supermarkets is local planning and zoning laws. Large supermarket chains are endowed with the resources to fight public protests and embark upon a public relations campaign which highlights the chains' benefits to the community. This may include benefits such as employment opportunities and an injection of wealth into the area. These benefits are particularly attractive to struggling local councils.

In contrast, independently operated supermarkets have fewer resources to achieve such effective lobbying and disseminate their community benefits while growing their businesses. Nonetheless, independent supermarkets offer local communities significant benefits beyond the capabilities of the chains. Store owner autonomy allows products to be sourced from the local area and thereby supports the local economy. Independent stores also draw on the local skills pool for secondary industries like accounting, legal, trades and IT services. This is strongly contrasted by the chains' emphasis on centralisation where this type of secondary industry is relayed back to a head office far removed from the local community. In this respect, independent supermarkets offer a far greater economic input into local communities than the chains.

Perhaps the most publically acknowledged contribution that independent supermarkets make takes the form of involvement in local communities. Independent supermarkets have developed a strong reputation for supporting local charities and clubs. This is largely due to the real interest and concern that store owners hold for their local communities. Independent supermarket owners view themselves as an integral part of the fibre of their local community and the contribution of their stores adds significantly to the social cohesion of the area. Given the enormous economic and social benefits that independents supermarkets contribute to their local communities, the restrictions of local planning and zoning laws operate as a counterintuitive check on the ability of independent supermarkets to grow, while the major chains retain several advantages in this regard merely due to their entrenched market power. Local governments should be allowed to take into account the long term benefits of independent supermarkets when assessing planning applications and would provide independent supermarkets with increased opportunities to provide even better competition to Coles and Woolworths.

## Conclusion

The grocery market has an immense effect on the lives of most Australians and the Australian economy. It is essential that the market is highly competitive in order to deliver to consumers the best possible grocery prices on an ongoing basis and to ensure increased productivity and growth. Independent supermarkets provide unparalleled benefits to this industry. They are a compelling competitive constraint on the prices offered by the chain supermarkets and, further, they provide very real benefits to their local communities. It is crucial that the genuine competition provided by independent supermarkets is not unfairly impeded so that the grocery industry as a whole remains dynamic, competitive and sustainable into the future.

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