P U B L I C   S U B M I S S I O N

National Association of Retail Grocers of Australia

Part B

ACCC inquiry into the competitiveness of retail prices for standard groceries

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1. Executive Summary

Australia has the most concentrated retail grocery sector in the world.

Operating in a population of only 21 million, Woolworths and Coles is each being described as among the top 30 retailers in the world.

The current inquiry by the UK Competition Commission has provisionally found that the concentration of the grocery industry there - five chains with 80 per cent of a market of 60 million people - has had an adverse effect on competition. How much more adverse must the effect of hyper-concentration be in Australia where 80 per cent of total grocery sales are in the hands of Woolworths and Coles supermarkets?

ACNielsen published its last national market share assessment in 2003, giving Woolworths and Coles 79 per cent of the national market for branded, packaged groceries. From 2001 to 2007, Woolworths and Coles opened an additional 218 stores, suggesting that their current market share is at least 80 per cent.

It is not safe to assume that the hyper-concentrated Australian grocery market is the result of "competition", of some sort of conscious choice, decision-making or preference by Australian grocery shoppers.

The market share of chain supermarkets is a direct result of their dominance of high-traffic, high volume sites in large shopping centres in major population areas - location, location, location.

As noted in another submission to this inquiry, supermarket usage for 'main' shopping activity in the United Kingdom broadly reflects the store footprints of each retailer.[1] In Australia, store choice is further restricted by both the hyper-concentration of the grocery industry and the concentration of retail space in shopping centre developments.

Choice of store might further be explained as a function of longer working hours, time-poor customers and the development of effective local monopolies or chain duopolies, particularly in the major cities where the number of convenient and easily accessible shopping options within a district may be limited.

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[1] Clarke, I., Kirkup, M., and Oppewal, H., *Are consumers getting what they REALLY want?* - Report of early findings from a major new study by the Advanced Institute of Management Research (AIM), submission 30 to the current inquiry.

People shop in chain supermarkets because those stores may be more convenient to where they live or work or perhaps it is less stressful to shop nearby than to drive to another shopping centre, not because the chains are more efficient or less expensive.

The concept of "competition" in the Australian grocery market is imprecise. Perhaps the first step in the current *Inquiry into the competitiveness of retail prices for standard groceries* should be that the Australian Competition and Consumer Commission defines its terms so that all stakeholders understand the issues being investigated and the basis on which the investigation is occurring.

The Commission has publicly stated its role as "protecting competition, not competitors", but the *Trade Practices Act* defines "competition" only to include competition from imported goods and "market" for a good or service only in geographic terms.

What, then, is the Commission protecting?

How is "competition" enhanced by reduction of the number of competitors? How might one "protect competition" within a supermarket chain duopoly when all other competition has been driven out of the market?

Submissions to this inquiry, daily media reports - and the very establishment of the current inquiry - suggest supermarket customers are dissatisfied with their grocery shopping options and with what they perceive as excessive and continuous price increases.

Market share growth by Woolworths and Coles has been the result of:

- a similar market concentration by retail property developers, who prefer major chain tenants for new stores in high traffic, high volume sites in major shopping centres;
- the acquiescence of regulators in purchases of significant numbers of the former Franklins and Action stores by the already dominant chains;
- "creeping" - store by store - acquisition of successful independent stores by Woolworths and Coles; and
- the lack of coherence between what one might regard as pro-competition policy development at national level and local government planning authorities' approval of development applications which undermine or preclude competition in local markets.

Nor is it safe to assume that consumers have consciously and deliberately preferred to shop at Woolworths or Coles because of the superior range or better service or cheaper prices.

On the contrary, there is ample evidence that the dominant supermarket duopoly has increased prices and profits significantly ahead of OECD averages and ahead of the Australian consumer price index for at least the past decade, regardless of periods of drought. Woolworths recent (February 2008) financial report notes a 28.1 per cent increase in net profit, based on an 8.6 per cent increase in sales. Supermarket sales have contributed the great majority of the profit increase.

Product ranges have been reduced by the major chains, brands deleted and replaced by house brands (often imported) owned by the supermarket chains - surely in itself anti-competitive - and both chains have shed thousands of employees in recent years, resulting in longer check-out queues and slower service times. These are matters of public record.[2]

Hyper-concentration of the retail grocery industry has also reduced scope for product innovation. Smaller suppliers with innovative product cannot afford the slotting fees, marketing and promotional contributions demanded by the supermarket chains. New product ranges or lines are more likely to be taken up initially by the independent sector and picked up later by the major chains when the risks associated with new lines have been reduced.

In one instance, a 2005 Dairy Australia "product of the year" winner, the Connoisseur Strawberry Stravaganza Ice Cream, did not reach supermarket chains' shelves until two years after release.

We recommend that the Commission's focus should be on ensuring that market concentration does not work to the detriment of other supply chain stakeholders, including primary producers, processors and manufacturers and consumers.

These are not hypothetical concerns, but practical questions at the heart of competition policy and regulation in Australia.

The National Association of Retail Grocers of Australia is pro-competition; we have an interest in contributing to the policy debate so that all players in the supply chain have the opportunity to compete fairly and so that

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[2] Thomson, J., *"Lean and Hungry at Work", Business Review Weekly, November 9-December 13 2006.*

real benefits of price, product range and service are delivered for consumers in every local market.

A consequence of such a situation would be one in which primary producers, processors and grocery manufacturers were also able to be competitive and innovative.

This submission will demonstrate, using the milk market as an example, that Woolworths and Coles extract a disproportionate percentage of the profits available in the supply chain, to the detriment of primary producers, manufacturers, retail competitors and consumers.

We shall also show that where the independent retail sector is strong there is a measurable improvement in price competition, using Sydney and Perth differentials as examples.

The Commission's own *Issues Paper* points to the excessive price increases which have occurred in the Australian supermarket industry compared with figures from the OECD and the Australian consumer price index.

Failure to rein in market share growth by Woolworths and Coles translates into protection of the interests of the two chains: the establishment of a duopoly allows that duopoly to share the market and increase prices at will. Ensuring that more players are able to compete fairly ensures that the competitive process is more efficient and delivers price and non-price benefits to all levels of the supply chain.

Either the *Trade Practices Act 1974* has been inadequate to the task of ensuring that those chains should not achieve hyper-concentration or the regulator's application of that law has been inadequate, or both.

The growth of the market share held by the chains is also a matter of public record and the rate of that growth is unique in the developed world: Australia is the only major economy with hyper-concentration of its grocery retailing sector.

NARGA strongly supports fair and vigorous competition in the national grocery market.

Current industry practices now put parts of the Australian food industry at risk: substituting imported canned food, for example, for Australian canned foods is not to swap like for like - issues of food quality, food safety and food security are involved and Australian food products rate high in all three areas.

NARGA strongly supports:

- more active intervention by governments and regulators to halt the continued concentration of the Australian grocery market;
- reform of the *Trade Practices Act* in relation to creeping acquisitions, predatory pricing and price discrimination;
- further reform of s46 in line with the expressed intentions of the Australian government;
- detailed review of whether local government planning decisions adversely affect pro-competition policies at national level.

2. BACKGROUND OF CURRENT INQUIRY

The National Association of Retail Grocers of Australia is a federation of State-based retailer associations nationwide. Our member organisations are:

- IGA Retail Network
- Retail Traders and Shopkeepers Association of New South Wales
- Master Grocers Australia
- Queensland Retail Traders and Shopkeepers Association
- WA Independent Grocers Association
- State Retailers Association of South Australia
- Tasmanian Independent Retailers.

Through these organisations, NARGA represents about 4500 independently owned and operated grocery retail businesses across all States and Territories.

Independent supermarkets and grocery stores employ 57 per cent of all employees in grocery retailing and turn over close to $15 billion a year.

Woolworths/Safeway and Coles/Bi Lo supermarkets turn over $59 billion, about 80 per cent of total grocery sales in Australia, but have only 43 per cent of employees in grocery retailing.

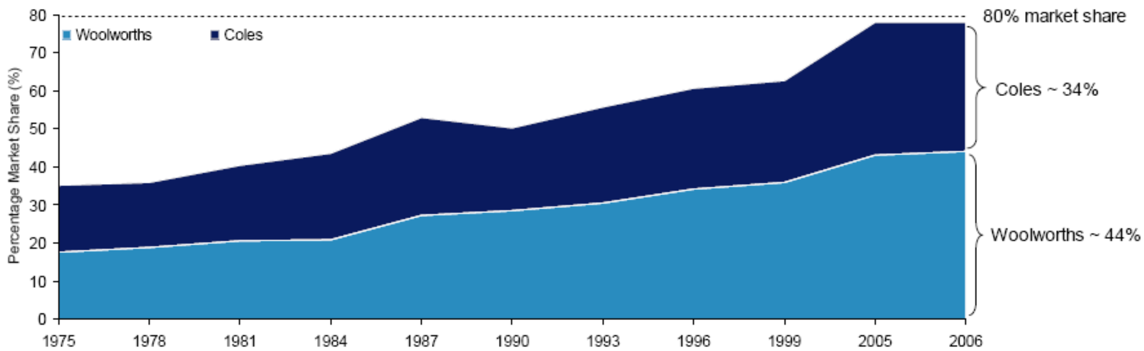
We should now regard the Australian grocery market as hyper-concentrated and realise that some of the theories which apply to competition law in other countries' grocery markets may no longer be appropriate in this country.

There is an urgent need to stop or reverse the process of market concentration which has been allowed to develop since the mid-1970s.

During the past 15 years, policy and regulatory approaches have, in our view, hindered a clear understanding of the consequences of market concentration for competition.

The following graph illustrates the growth in Woolworths and Coles grocery market share since 1975[3]:

Figure 2.10: Growth in market share of Woolworths and Coles, 1975-2006



Source: Retail World, ACNielsen

Hyper-concentration reduces competition and leads to market sharing.

The period covered in Figure 2.10 coincides with the operation of the *Trade Practices Act 1974* and demonstrates that the legislation has been ineffective in preventing the hyper-concentration of the Australian grocery market. Thus, either the legislation is inadequate or the interpretation and application of the law by the regulator, or both, may be contributing causes of market concentration and grocery price inflation.

The current *Inquiry into the competitiveness of retail prices for standard groceries* is a direct result of public concerns about the practices of the two major supermarket chains. Hyper-concentration of the grocery market has allowed the major supermarket chains to move into realms beyond traditional concepts of competition.

Competition theory does not account for behaviour of competitors in hyper-concentrated markets, but rather assumes that such hyper-concentration is to be avoided.

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[3] PricewaterhouseCoopers, *The economic contribution of small to medium-sized grocery retailers to the Australian economy, with a particular focus on Western Australia.*

In its decision of 7 February 2003, the High Court found in the Boral case[4] by a six to one majority that "*The essence of … market power ... is absence of constraint from the conduct of competitors or customers.*"

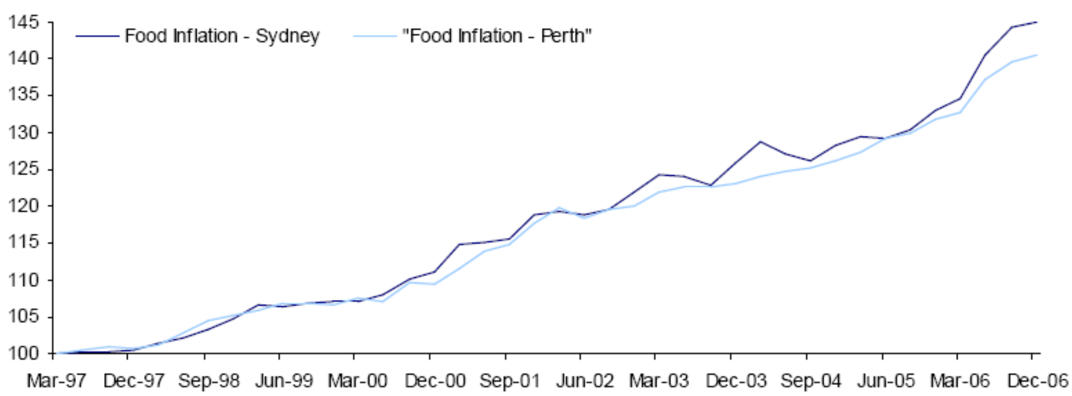
The Boral case related to alleged predatory pricing in the market for concrete masonry products in the late 1990s.

Whether or not the High Court's view of market power applied in the national grocery market in 2003, it does now. Both major supermarket chains act with impunity in exercising market power unconstrained by the conduct of suppliers, competitors or customers, raising prices at will to increase profits and satisfy the share market's expectations of growth quarter on quarter, year on year.

According to their most recent company statements, they plan further expansion and market share increase, unconstrained by considerations of public interest.

In the Perth metropolitan grocery market, where independent retailers have a stronger position (32 per cent of the market) than in Sydney (15 per cent), the effects of greater competition can, in our view, be seen in lower food price inflation[5] with a rate three per cent lower:

Figure 5.6: Comparison of food price inflation in Sydney and Perth



Source: ABS Cat. 640103

This demonstrates that independent grocery retailers, competing head to head with the major supermarket chains, can exert competitive tension in the market and bring about lower prices.

[4] Boral Besser Masonry Limited v Australian Competition and Consumer Commission [2003] HCA 5.
[5] PwC, p. 38

Specifically, NARGA spot-checked prices between a relatively small IGA store in Perth and much larger Woolworths and Coles stores in Sydney on 28 February 2008:

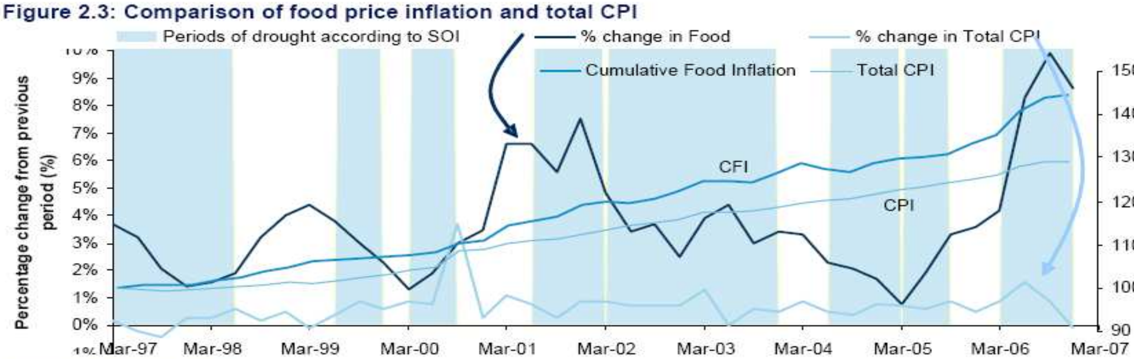
	IGA PERTH	COLES SYDNEY	WOOLWORTHS SYDNEY
Birds Eye Peas 500gr	1.78	1.92	1.88
Kraft Dips 250g	2.98	3.31	3.25
Cadbury Chocolate 250g	4.39	4.48	4.69
Kelloggs Corn Flakes 525g	3.94	4.10	3.95
Nutri Grain 345g	4.89	4.99	4.89
Milo 750g	7.79	8.97	8.79
Continetal Cup A Soup	1.83	2.03	1.89
Heinz Baked Beans 420g	1.40	1.50	1.59
Heinz Tomato Sauce 600ml	1.78	1.93	1.89
Omo Conc 1kg	5.89	6.01	5.89
Vegemite 400g	5.95	6.07	5.95
Coca Cola 2ltr	2.99	3.20	3.15
Coca Cola 1.25ltr	1.84	1.93	1.89
TOTAL	47.45	50.44	49.70
% HIGHER		6.3	4.74

The prices in this survey were collected from a relatively small independently owned IGA store in Perth and a Woolworths store in Sydney six times larger by floor space and with weekly turnover eight times greater than that of the IGA store. The Coles store is of a similar size and turnover to the Woolworths store.

Can drought explain grocery price increases? Not entirely, although the impact of drought is greater in some areas of primary industry than others.

The following graph demonstrates that grocery prices have increased steadily over the past decade, regardless of periods of drought, as indicated by the blue bands:[6]

Figure 2.3: Comparison of food price inflation and total CPI



Source: ABS Cat. 640102

There has been for many years a high level of public concern about continuous increases in grocery prices. Clearly, the supermarket chains which now share at least 80 per cent of the market are the price setters for the industry and other competitors follow.

One cannot fail to notice the disparity between Woolworths' assertion that savings and efficiencies in the supply chain are being passed on to consumers in the form of lower prices - and the indisputable evidence which is on the public record that grocery price increases in the Australian market are ahead of other economic indicators and have been for at least a decade.

On 26 February 2008 Woolworths released its profit report for the 27 weeks ended 30 December 2007, including a 28.1 per cent increase in net profit, based on an increase in sales of only 8.6 per cent

The EBIT (earnings before interest and tax) increase was 20 per cent up on that of the corresponding period of the previous year.

Their food and liquor EBIT is now $998.7 million out of EBIT of $1,374.9 million for the total Woolworths business.

In a nation of only 21 million people, Woolworths and Coles have each established themselves among the top 30 retailers in the world.[7]

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[6] Ibid., p. 7.

[7] *The West Australian* online version, 19 March 2007, quoting financial services firm Deloitte.

Woolworths' tells investors it has a strategy which includes "leveraging our strategic supply chain advantages across the Woolworths businesses; continued investment in price range, merchandise and quality in all our businesses and focussing on a number of key strategic initiatives that will drive future growth."[8] That translates as "more price rises".

While Coles supermarkets are currently in a transitional period under new ownership and awaiting the arrival of a new chief executive, there is no reason to believe that Coles will in the future behave in a way that is notably different from that of Woolworths. Coles will, of course, attempt to recoup and grow the investment of Wesfarmers Limited, as they should. But that will contribute to pressures towards market domination by the large supermarket chains.

3. MILK PRICING – AN EXAMPLE OF THE 'WATERBED EFFECT'

Since the deregulation of the milk market, prices that used to be set by regulation are now set by retailers. This section examines what has happened to milk prices since deregulation in July 2000, using current WA consumer pricing as a case study. The WA figures are indicative of those of other States.

MILK PRICES IN WA – FEBRUARY 2008

	Reg			Hi Lo		
	Coles	W/Worths	IGA Glen	Coles	W/Worths	IGA Glen
Brownes						
3ltr	4.59	4.31	4.78	4.59	4.57	5.04
2ltr	3.40	3.40	2.99	3.26	3.26	2.99
1ltr	1.90	1.90	1.49	2.04	2.04	1.49
Masters						
3ltr	4.69	4.69	4.59	---	4.57	4.98
2ltr	3.47	3.47	3.44	---	3.48	3.48
1ltr	1.99	1.99	1.73	---	2.11	1.73

[8] Woolworths Limited press release: *Profit report and dividend announcement for the 27 weeks ended 30 December 2007*, 26 February 2008.

Home brand						
3ltr	3.79	3.79		4.29	4.29	
2ltr	2.59	2.59	2.69	2.99	2.99	2.69
1ltr	1.48	1.48		2.11	---	
Harvey Fresh						
3ltr	5.10	5.04	4.19	5.10	4.49	4.19
2ltr	3.55	3.50	2.99	3.65	3.59	2.99
1ltr	1.85	2.04	1.80	1.80	2.04	1.80

Black & Gold milk – 2L was priced at $2.59 – for both regular and low fat varieties.

Data from Dairy Australia[9] shows how changes in milk pricing confirm that a 'waterbed effect' has developed since dairy deregulation occurred in 2000. The 'waterbed effect' is the term used to describe the result when a large player in a market demands lower wholesale prices from suppliers, forcing those suppliers to increase prices to other customers to bring earnings back to a sustainable level. The large body in the middle of the waterbed forces up smaller bodies on the sides.

The Dairy Australia reports show that in 2000/01 the supermarket sector sold 1,016 million litres of milk, comprising 591 million litres of branded product and 425 million litres of private label product.

By 2005/06 (latest data available from DA) supermarket milk sales had grown to 1,180 million litres (in a relatively static milk market), with 531 million litres of branded product and 650 million litres of private label product.

This suggests that private label sales had grown from 41.8% of sales to 55.1% of sales.

During that period, the average shelf price of branded regular milk has increased from $1.27 per litre to $1.52 per litre – an increase of 25c per litre or 19.6%, whilst the price of private label milk increased from an average of $1.06 per litre to $1.11 per litre – an increase of 4.7%.

Prices for branded regular milk in indicative markets have increased by a further 30c per litre since the that time.

[9] Dairy Industry in Focus: 2003 and 2006, Dairy Australia

The data clearly suggests that the low prices paid for private label milk are being supported by higher prices in the branded milk range, giving large supermarket chains a competitive advantage at the expense of smaller stores.

In other words, the deregulation of the dairy industry and the domination of the retail milk market by Woolworths and Coles has resulted in higher average milk prices.

The absence of price discrimination legislation allowed such a situation to develop.

The following questions arise:

- Since the introduction of house brand milk by the supermarket chains, have they increased their margins disproportionately to those of the farmers and processors?

- Why do the major chains charge up to 20c per litre more for their low fat varieties than they do for whole milk?

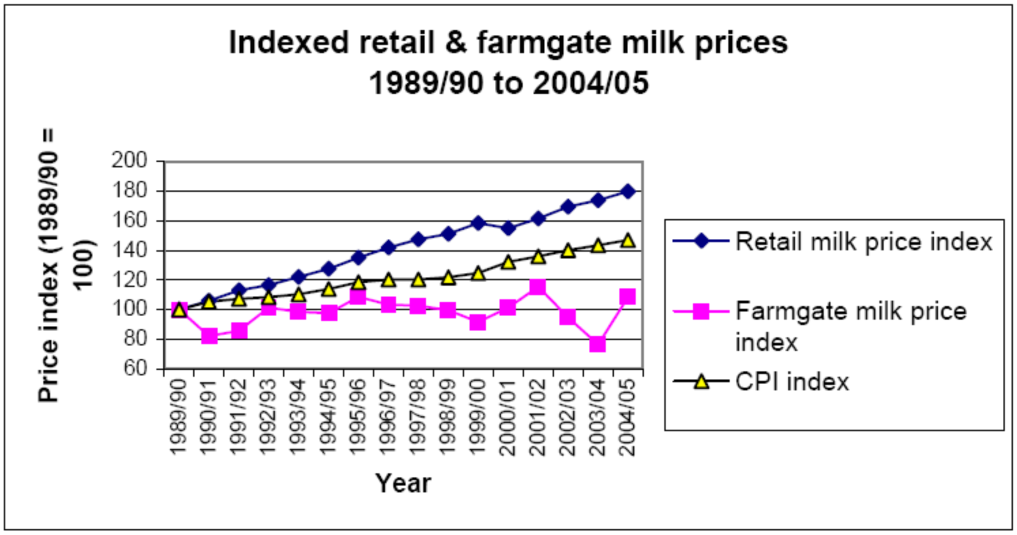
- Why can independents sell the most popular size (2L) of milk at a lower price than the major chains?

- Why is there such a significant difference between branded and 'home brand' prices, which come off the same filling line and are in identical (but differently labelled) packs?[10]

Dee Margetts, in a paper on dairy market deregulation[11], submitted to the current inquiry, draws a number of conclusions:

- '….average milk prices in Australia continue to climb at a rate which exceeds CPI, whilst farmgate prices have fluctuated but generally remained low…' (p.81) – See graph below.

[10] Pricing differentials between branded and 'own brand' milk are greater in east coast states.
[11] Competition Policy: What's that got to do with the price of milk? – Dee Margetts, UWA Business School, Australian Global Studies Research Centre. Submission 005.



Data sources: ABS, ABARE 2005d [69]

- 'On the retail level, there is no question that the sector is more concentrated than ever before, and it is argued that the oligopsonistic power that this provides has been to the detriment of Australian dairy producers…' (p.82)

- '…as strong co-operatives appear to be necessary to retain a reasonably healthy bottom line in farm gate prices, their future loss in the face of increased retail dominance is likely to be significant.' (p.82)

Ms Margetts has not examined the question of margins in her paper, but light is thrown on that matter by a recent study conducted at the University of Oxford[12], which clarifies where the bargaining power lies in price negotiations.

The study provides evidence that the supermarkets held the majority of the bargaining power in the supply chain and end up with nearly 90% of the total available supply chain margin – the remaining being shared between the processor and the farmer.

Farmers are in the weakest position and are only able to secure about 3% of the total supply chain margin, revenue from which they must meet all of their costs.

While the study refers to the UK market for milk, it should be recognised that both the retail and processing sectors in Australia are markedly more concentrated, which suggests that the power relationships here could be equally skewed.

[12] The Milk Supply Chain Project, Smith H. and Thanassoulis J. University of Oxford, Jan 2008 for DEFRA and MDC

Milk prices at retail have increased substantially since deregulation – at a rate substantially greater than farm gate prices. The gap between branded and generic (own brand) milk has also increased.

A number of questions arise:

- Why has the price of milk to consumers increased at a rate greater than the rate of increase of farm gate prices?

- Is the margin within the supply chain increasing and where is the additional margin being taken?

- What is the basis of the price differential between branded and generic milk? (It cannot be reflective of volume purchasing benefits as fresh milk is a 'direct delivery' item – i.e. branded and generic milk are delivered to the store on the same truck.

- To what extent is the lower price of generic milk attributable to supermarket buyer power?

- To what extent has the lower price paid for generic milk resulted in higher prices being paid for branded milk?

- Has this dual pricing approach by processors resulted in an overall increase in the average retail price for milk?

- Is the 'waterbed effect' operating in the milk market?

The 'waterbed effect' has the following characteristics:

- Major chains use their buyer power to demand a lower price for a particular product (e.g. generic milk) – a price that could be below the cost of production.

- The producer needs to charge a higher price on the balance of that product's sales (branded milk) in order to stay viable.

- The result is that the major chains have a substantial price (and margin) advantage over non-chain competitors and are able to sell the generic product at a lower price than the branded product.

- The higher price placed on the branded product allows the major chain to increase the price for the generic product.

- The result is that retail prices have increased across the board, and the average retail price paid by the consumer is substantially higher than it was before the discounting of the generic product started.

4. GROCERY MARKET SHARE IN AUSTRALIA

Market share data are matters of objective fact, not matters of opinion or debate or personal preference.

As recently as the early 1990s, Woolworths and Coles were wont to quote ACNielsen market share figures as the basis for their claims of success in increasing their shares of the Australian grocery market. Those figures were based on *branded, packaged grocery products,* derived from electronic scan data.

By the end of the decade Woolworths, under the pressure of public and political scrutiny of its dominant position in the Australian market, had switched to quoting broader Australian Bureau of Statistics figures as the basis for their market share calculations. Coles did not.

The Australian National Retailers Association (ANRA) represents major national retailers, including Woolworths and Coles, and never deviates from the Woolworths line on any issue.

In response to the announcement (July 2007) by the then Opposition Leader, Mr Rudd, that a Labor government would establish a national grocery pricing inquiry, the ANRA claimed Woolworths and Coles combined market share was 52 per cent,[13] with Woolworths at 29 per cent and Coles at 23 per cent. Woolworths' own statements refer to similar numbers.[14]

The ABS data are a broad statistical collection, not data from an actual commercial market. By extending the statistical boundaries to all food, liquor and groceries sold in Australia, Woolworths pretends its statistical share is smaller - it is not, however, a share of a "market".

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[13] ANRA media statement, *Australian National Retailers Assocaition (ANRA) response to Kevin Rudd's pledge to launch a National Grocery Pricing Inquiry into supermarket food prices,* 11 July 2007.

[14] Woolworths Limited press release, *Woolworths welcomes Grocery Prices Inquiry,* 22 January 2008; Mr Roger Corbett, AM, former Woolworths CEO, evidence to Senate Economic References Committee, 30 October 2003, pE4.

The ABS figures indicate that total retail food sales in Australia are worth almost $98 billion, of which supermarket and grocery sales account for 62 per cent, or about $60 billion[15]. Woolworths combines the ABS food retailing data for *supermarkets and grocery stores* with their data for *takeaway food retailing* and *other food retailing* to make their share of this broader statistical collection look smaller than it is in packaged grocery sales.[16]

But it is a false comparison because Woolworths are not in all of those markets.

Do people go to Woolworths on Friday evening after work for a dry martini in the bar? Does the under-12 football coach take his team to Woolworths for a burger and fries to celebrate their grand-final win? Does anybody call Woolworths to order a pizza for home delivery? Does either of the supermarket chains operate five star restaurants?

Why would Woolworths try to convince people they are small? It's not a line they repeat when handing down financial results, because in that context they are trying to convince share market analysts and investors that they are, indeed, huge and planning to get a lot bigger. That perception, they hope, will be reflected in higher share prices.

Any person who has ever entered a major chain supermarket knows what they have seen: aisle after aisle with shelves stacked with packaged groceries.

The ACCC's *Charter for the Competitive Sale of Independent Supermarkets* - to which Woolworths and Coles are signatories - defines "supermarket" as *a business retailing groceries, including liquor and household goods.*

Packaged groceries constitute the largest category in any supermarket and are therefore a valid proxy for overall market share.

That is also why Woolworths and Coles are regarded as *supermarkets* or *grocery retailers* rather than butchers or fruit and vegetable retailers or delicatessen operators: retailing of packaged grocery products is by far their major activity.

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[15] Commonwealth Department of Agriculture, Fisheries and Forestry, *Australian Food Statistics 2006,* p. 2.

[16] Australian Bureau of Statistics, *Retail Trade* (8501.0) December 2007.

Another way to look at market shares is to consider each of the product categories which are the main focus of the current ACCC inquiry - so-called "standard groceries". Those specifically mentioned in the ACCC's *Issues Paper* include dairy products, bread and cereal products, meat and seafoods, fruit and vegetables, non-alcoholic drinks and snack foods and other foods (such as coffee, spreads, etc.). In each and every one of those markets Woolworths and Coles jointly account for the largest block of sales.

Until 2003, ACNielsen published overall grocery market share figures.

They no longer do so and have never publicly explained why, but we believe it is because ACNielsen's business in large part depends upon sale of scan data (that is, transaction data from scanning checkouts) the largest components of which are provided to them by Woolworths and Coles. Woolworths, we infer, now provide the data on the condition that market share figures will not be published.

Woolworths' purpose is to muddy the waters about its actual size and to evade scrutiny by restricting the availability of any data which might be used against it.

The reason is simple: Woolworths has attempted to redefine the market because, at 45 per cent market share, it is already beyond the trigger threshold of the ACCC's *Merger Guidelines 1999*, which specified:[17]

> 5.95 If the merger will result in a post-merger combined market share of the four (or fewer) largest firms (CR4) of 75 per cent or more and the merged firm will supply at least 15 per cent of the relevant market, the Commission will want to give further consideration to a merger proposal before being satisfied that it will not result in a substantial lessening of competition.[65] In any event, if the merged firm will supply 40 per cent or more of the market the Commission will want to give the merger further consideration. The twofold thresholds reflect concerns with the potential exercise of both coordinated market power and unilateral market power.[66]

Woolworths and Coles together have 80 per cent of the market, Woolworths is three times the single company figure and Coles twice it. Together they exceed the ACCC's market share trigger for four companies.

Clearly, acquisitions by the chains in recent years, for example the purchase by Woolworths of the *Action* supermarkets formerly owned by

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[17] ACCC, *Merger Guidelines 1999, and footnote.*

Foodland Associated Limited in Western Australia and Queensland, have been contrary to the spirit of the ACCC's own guidelines.

Yet the ACCC approved the purchase, lifting the chains' combined market share by about three per cent.

We acknowledge that the *Merger Guidelines* are currently under review, but strongly recommend that thresholds be maintained and that the ACCC be more rigorous in applying them.

We draw the Commission's attention to the fact that the *Trade Practices Act 1974, s50(2)* requires the Commission to consider whether an acquisition would result in or be likely to result in a substantial lessening of competition in a market, which *s50(6)* defines as regional, State/Territory or national.

We suggest the legislation should not be regarded as a menu from which one option may be chosen; we believe *all three levels* of market should be considered simultaneously. That is, after all, what actually happens: market cumulation at local level results simultaneously in market cumulation at State/Territory and national levels.

Such a simultaneous assessment would bring into sharper relief the consequences of market share growth through creeping acquisitions. If local market share cumulation is allowed to continue, it inevitably results in State and national market cumulation, which has consequences for competition at those levels.

The last published ACNielsen combined market share figure for Woolworths and Coles was 79 per cent at November 2003 and that figure has been used as a rule of thumb since then. However, total store numbers operated by the chains give further insight.

In 2001, Coles operated a total of 630 stores under its various banners. Woolworths operated a total of 661 under its banners. That is a grand total of 1291.

By November 2007, Coles operated a total of 753 and Woolworths a total of 756, a grand total of 1509[18]. New stores have opened even since then.

On the basis that the combined number of stores now operated by the chains is at least 218 more than in 2001, one can reasonably conclude

[18] Source: *Retail World Annual 2008.*

that the combined market share of Woolworths and Coles now is likely to have been maintained or increased.

But there's more.

Woolworths financial report of 26 February 2008 spells out its plans to "continue space roll out", including:

a. 15-25 new supermarkets a year plus expansion of existing stores (3% pa)
b. 6-10 BIG W stores a year (6% to 8% space rollout pa)
c. Up to 15 Dan Murphy's stores a year
d. Continued planned store efficiency improvements
e. Greater store refurbishment and extension programme across all divisions.

The report says the projection is "supported by detailed plans for the next three to five years identifying specific sites. Minimal cannibalisation."

Coles Group's *Full Year Financial Results and Market Update,* 19 September 2007, foreshadowed 28 new supermarkets in financial year 2008.

Some might point to ALDI in the context of market share assessment. ALDI occupies a unique place in the Australian market. The company now has more than 200 stores here, but is not a full market competitor, offering a range of about 600 product lines, mostly own brands, which compares with an average independent store's offering of about 16,000 product lines. An Australian household could not rely on ALDI alone as a source for all its weekly grocery requirements.

The UK Competition Commission similarly classifies ALDI as a Limited Assortment Discounter (along with Lidl and Netto in the UK market) and not a full competitor for Tesco, Asda, Sainsbury, Morrisons, CGL, M&S, Somerfield or Waitrose.[19]

On the basis of past performance and with planned new store openings and refurbishments, the independent sector is likely to be able to maintain overall market share and in some instances grow market share.

[19] UK Competition Commission, *The Supply of Groceries in the UK: market investigation, Provisional findings report, 31 October 2007, p. 38.*

The great impediment to maintenance and growth of market share by the independent sector is the continued ability of Woolworths and Coles to acquire stores one by one, using the contradictions inherent in the ACCC's approach of assessment of local market competition without acknowledging the consequences for national market share and competition.

5. PROTECTING COMPETITORS OR PROTECTING COMPETITION?

The Australian Competition and Consumer Commission has taken the view that its role is to "protect competition, not competitors".

Failure to act to prevent the hyper-concentration of the Australian market or acquiescence in further concentration is indeed to protect the position of particular competitors - those which have been allowed to achieve, and currently enjoy, unprecedented levels of market domination and who continue to add market share through creeping acquisitions.

While one might agree, as we do, with the proposition that the competitive process needs to be maintained and that inefficient, unviable or incompetent competitors should not expect to be protected from better competitors, in Australia's hyper-concentrated grocery market the context is qualitatively different, since the market power of two huge competitors outweighs the combined power of all others, as well as that of suppliers and consumers.

The idea of protecting an abstraction is now being seen internationally as misguided. The Global Competition Law Centre argues:

> *First, competition cannot be protected for competition's sake: conduct only adversely affects competition where it operates in some sense to the detriment of consumer welfare. As made clear by Advocate General Jacobs in* Bronner, *'the primary purpose of Article 82* [of the EC Treaty] *is to prevent distortion of competition and in particular to safeguard the interests of consumers - rather than to protect the position of particular competitors.'*[20]

As we have noted above, the position of certain competitors is, indeed, being protected at present by lack of regulatory intervention. In Australia,

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[20]Global Competition Law Centre, *GCLC Research Papers on Article 82 EC*, July 2005, p.57 and footnote.

it could be argued that the purpose of competition regulation should be to protect suppliers, competitors and consumers from the adverse effects of market concentration so that genuine competition is enhanced.

In the Australian market, two dominant supermarket chains - because of their market power - are able to prevent effective competition from being maintained, to the detriment of suppliers, competitors and consumers. Grocery price increases at significantly higher rates than OECD averages, as noted in the ACCC's *Issues Paper,* and ahead of the Australian consumer price index are evidence of this.

The ACCC's 1999 *Merger Guidelines* recognise that demand side market power can result in adverse impacts on competition:

> *The preceding discussion has centred on the exercise of market power and potential lessening of competition on the supply side of the market. However, it is also possible for market power to be exercised in an analogous way on the demand side.* ***Where firms have market power on the demand side of the market they may be in a position to impose a significant price decrease, or other deterioration in terms, on sellers, depressing output below its competitive level.***[21]

Consider the situation of a major national grocery supplier, dealing with two customers taking 45 per cent and 35 per cent of his production respectively. Unless that manufacturer is prepared to lose 45 or 35 per cent of his sales, or both, his ability or willingness to resist intimidation or risk retribution from either customer is virtually non-existent.

A direct result of such market power is a substantial lessening of competition, because the companies wielding that power are in a position to extract various benefits from suppliers who have little or no countervailing power. The extracted benefits may then be used against competitors, either through offering on core lines lower retail prices which cannot be easily or profitably matched, or by increasing the profit margins of the retailer. In the latter case, additional funds are then available for activities, such as new store developments or acquisitions, which further enhance market power or reduce the number of competitors in the market.

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[21] ACCC, *Merger Guidelines 1999,* p. 26.

Market dominance equates to substantial market power. Those familiar with the High Court's decision in the Boral case will see the parallels in the following:

> "…*The European Commission considers that 'market power is essentially measured by reference to the power of the undertaking concerned to raise prices by restricting output without incurring a significant loss of sales or revenues.'"*[22]

In our view, it is up to the competition regulator to enhance the competition environment by ensuring that large corporations are prevented from using market power in ways that are immediately or potentially anti-competitive. The first step is to halt further market concentration. NARGA will support any legislative proposals intended to achieve that objective. The alternative, a continuation of unrestricted market share growth by Woolworths and Coles, is clearly not in the public interest or the interests of the Australian food industry.

If the trend in market concentration is allowed to continue, we will arrive where we are headed.

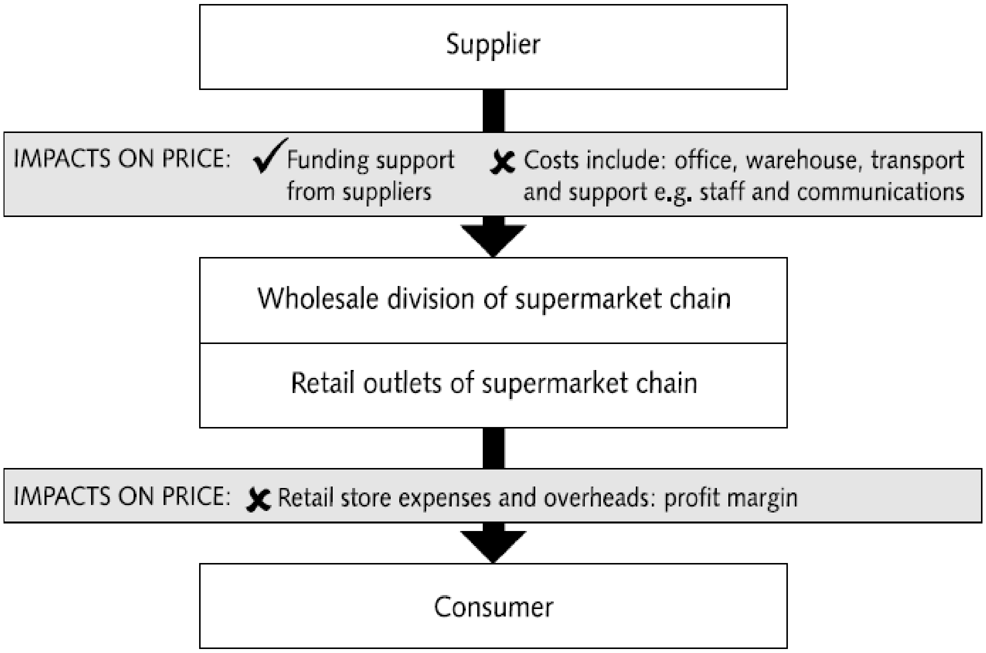
6. THE ACCC'S MARKET MODELS ARE FLAWED

The following models are from the *Report to the Senate by the Australian Competition and Consumer Commission on prices paid to suppliers by retailers in the Australian grocery industry,* September 2002, pursuant to the Order of the Senate of 8 February 2001.

The first purports to be a model of how the major supermarket chains function. It assumes that wholesaling and distribution functions of the supermarket chains operate in a way that has no impact on price beyond normal administrative costs, offset in whole or in part by funding support from suppliers.

[22] Global Competition Law Centre, op. cit., p. 8.

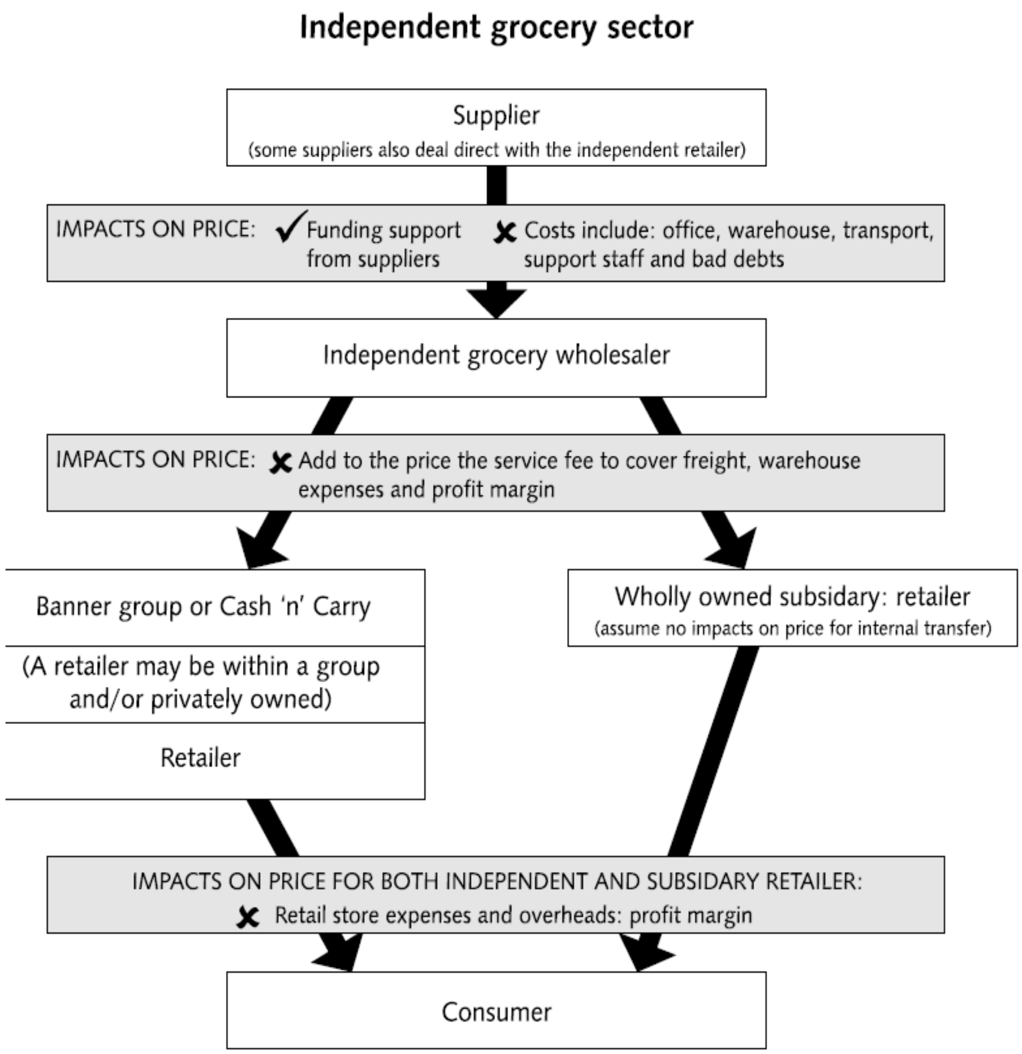
Supermarket (major retail) chains



The model suggests that the only costs between supplier and consumer are the "retail store expenses and overheads" and, at most, part of the office, warehouse, transport and support costs are wholesale level.

The model is misleading. Both supermarket chains operate their wholesale buying and distribution divisions as profit centres. The prices passed on to the retail division include profits earned by the wholesaling and distribution division and they then become part of the base cost for a further profit increase at retail level in the prices paid by shoppers.

Take into account the fact that the supermarket chains wholesale and distribution operations mirror those applying in the independent sector and the model would look no different from the ACCC model for the independent sector, in which the Commission attributes an *extra* level of cost which it claims the chains neither carry nor pass on:



The ACCC models assume that the supermarket chains operate more "efficiently" than does the independent sector, when this is not the case.

From another perspective, the proposition that two huge corporations are sufficient in a market breaks down when confronted with what has actually occurred in the Australian grocery market.

Woolworths and Coles are now so large, their operations so complex, that few apart from very senior managers responsible for specific areas of those businesses are able to understand what is happening on a day to day basis. Multi-million dollar deals are commonplace.

There are inherent efficiencies in the independent sector which are not available to Woolworths and Coles, including nimbleness and quick response times to market needs.

Independent grocery retailers are also able to:

- Buy direct in their local markets, ensuring product is fresh and nutritious
- Lower wastage
- Eliminate unnecessary layers of middle management.

It should also be noted that an independent retailer is likely to purchase from the major wholesaler as little as 45 per cent of what he sells, sourcing the rest direct.

7. UK COMPETITION COMMISSION INQUIRY

The UK Competition Commission released on 1 November 2007 its interim report on its inquiry into the UK grocery market. The UKCC has since released further discussion papers and potential remedies which it has under consideration in relation to its interim findings.

Their final report is due to be released in April 2008.

From Australia's point of view, the key interim finding was that grocery market concentration in the UK - where five supermarket chains share 80 per cent of the market, compared to the Australian situation where two supermarket chains share at least 80 per cent - had had an adverse effect on competition.

A similar circumstance surely applies in Australia, so the UK inquiry is worth noting.

OFT Reference

The Office of Fair Trading (OFT) referred the grocery industry to the Commerce Commission for inquiry in May 2006. The principal reasons for this reference were concerns re the distortion of competition that could result in harm to consumers, based on the following features of the grocery market:[23]

- 'The planning system can reasonably be suspected of restricting or distorting competition by raising the cost of, and also limiting

[23] The Grocery Market – The OFT's reasons for making reference to the Competition Commission, UK Office of Fair Trading, May 2006

the scope for, new local market entry, particularly by way of new large format stores.

- There are reasonable grounds for suspecting that the landholdings of the large supermarket multiples may reinforce their existing market position in some local areas. The OFT has also found evidence of practices that could have an anti-competitive effect, including the use of restrictive covenants in relation to sites sold by the big supermarkets.

- There is evidence to suggest that the buyer power of the big supermarkets has increased since 2000, and that the differential between suppliers' prices to large supermarkets compared with those to wholesalers and buying groups has risen. Against the background of greater concentration within the market, there are reasonable grounds for suspecting that this buyer power could harm consumer choice by undermining the viability of alternative business models including wholesale distribution to the convenience store sector.

- Aspects of the larger supermarkets' pricing behaviour – below cost selling and price flexing – also provide reasonable grounds for suspecting that competition is being distorted, though the extent of the possible distortion is unclear. Although the OFT has not found evidence that consumers are being harmed as a result of these pricing practices, A CC market investigation would be able to examine in greater detail the effects that these practices may be having on competition and consumers.'[24]

Commerce Commission Issues Paper

In an issues statement based on the OFT's decision document the Competition Commission summarised the issues relevant to the grocery industry as follows:

'(a) whether any aspect of the behaviour of grocery retailers towards their suppliers affects competition in any market;

(b) whether any aspect of the structure of any local market for groceries, or any aspect of the conduct of grocery retailers or consumers in the market for groceries (or in any other market in

[24] Ibid

which grocery retailers operate) affects competition in one or more local markets for groceries, or in any other product market; and

(c) whether the operation of the planning regime as it affects grocery retailing, or any conduct by grocery retailers, including any aspect of the acquisition, disposal, development or use of land, affects competition in any market.'[25]

The document went on to outline all of the factors of the grocery market that would be investigated by the Commission.

Progress of the Inquiry

Throughout the investigation the Commerce Commission released copies of a wide range of working papers, studies and reports. An early review document – *Grocery Market Investigation – Emerging Thinking,* issued in January 2007 gave some insight as to how the regulator viewed the grocery market, as demonstrated by the following comments:

- '….we consider larger grocery outlets to be an effective substitute for smaller grocery outlets, and as a result, these larger stores constrain the prices, and other non-price competitive variables, such as product quality, product range and service (together the 'retail offer') of smaller stores. However, we do not currently view smaller grocery outlets as providing a similarly effective substitute for larger grocery outlets' (p.5)

- '….Upmarket grocery retailers, such as Marks & Spencer (M&S), may be in a separate product market from Limited Assortment Discounters (LADs), such as Aldi.' (p.6)

- '…..retail markets for the supply of groceries are, essentially, local.' (p.6)

- '….. (evidence) points to grocery retailers earning an increasing share of milk revenues compared with processors and farmers, but is less clear in relation to pig meat…' (p.6-7)

- 'Concerns have also been raised with us regarding aspects of grocery retailers' behaviour towards their suppliers such as unilateral changes in trading terms and requirements for lump sum payments. Many suppliers, however, have been reluctant

[25] Grocery Market Investigation – Statement of Issues, UK Commerce Commission - undated

to provide us with details of specific instances to illustrate the general concerns that have been raised with us due to concerns of possible retaliation by grocery retailers.' (p.8)

- 'Regarding the structure of local markets…..a very preliminary analysis indicates that only 35 per cent of the urban population in the UK has a choice of at least three different grocery outlets larger than 1,400 sq metres within a 10 minute drive time…. The respective percentages in rural areas are less than 5 per cent…'(p.8)

- '….we have identified ten grocery retailers that engage in below-cost selling, although the extent of below cost selling is small in the context of their total revenues. Our current thinking is that predatory strategies towards smaller grocery retailers and specialist stores appear to be feasible in certain circumstances. We also consider that below cost selling by larger grocery retailers may also unintentionally contribute to the exit of smaller grocery retailers and specialist stores.' (p.9)

- 'In relation to price flexing (ie the practice of varying prices between stores), Asdam Morrisons, Sainsbury and Tesco each have national price lists for goods but all adjust their offering at the local level…..A number of other grocery retailers, however, have told us that they set their store price according to the local level of competition.' (p.9)

- 'The CC has previously found that high levels of concentration, high levels of price monitoring and stable demand in grocery retailing are conducive to the presence of coordinated effects.' (p.9)

- 'Although some individual cases have been brought to our attention it is not clear to what extent they are evidence of systematic or widespread use by major retailers of the planning system to gain a competitive advantage…'(p.10)

- In relation to land….an initial analysis confirms Tesco's pre-eminent position in terms of the holding of land for retail development….We have carried out some initial analysis of the ways in which land holdings might be used to impede entry bu competitors into local markets….' (p.10)

- 'Finally (there) is a general concern that the position of the major grocery retailers, individually and collectively, is so strong that it is distorting competition to an unacceptable degree. This concern often focuses on one major grocery retailer in particular on account of its national share of grocery retailing, holdings of land for development, ubiquity of operations and extension into non-grocery retailing.' (p.10)

The *Emerging Thinking* paper was accompanied by a series of papers on different aspects of the industry. The paper on *Store margin Analysis* made the following comments in relation to competition at the local level:

- 'Competition is local as there is evidence that the number of rivals located close to a store affects its performance' (p.1)

- 'The magnitude of the affect is likely to be understated by simple regression analysis…' (p.1)

- '….using this approach we find a significant effect on store performance from there being at least one competitor store within 10 minutes.' (p.2)

- '…the further away is the extra competitor, the less is the effect on store margin.' (p.9)

- 'The results show that the effect on store margin of an extra competitor store within 10 minutes is negative and statistically significant….' (p.11)

- 'The results show that there is a statistically and economically significant difference in store margins that have no competitor store within a 10 minute isochrone, and those that have at least one competitor store…'(p.13)

- 'In these results, ….store margins are, on average, about 9% lower when there is at least one competitor store over 1,400 sq metres within 10 minutes compared to when there are no competitor stores over 1,400 sq metres.' (p.13)

Provisional Findings

The Commission issued its *Provisional Findings* in October 2007. The following comments and findings are pertinent:

- The market is seen as being composed of three segments – larger stores (1000 – 2000 sq metres)m mid-sized stores (280 – 1000 sq metres) and convenience stores (less than 280 sq metres). (p. 255)

- LADs (e.g. Aldi) are not seen as being in the same market. (p.255)

- The geographic market for the supply of groceries by grocery retailers is local…..In setting those elements of their retail offer that are applied uniformly, or near uniformly, across their stores, grocery retailers will take into account the extent to which they face competition, and the identity of their competitors, in different local markets. (p.256)

- In relation to the three product markets identified:

    - Larger grocery stores will, in general, be constrained by other larger grocery stores within a 10 – 15 minute drive-time
    - Mid-sized grocery stores will, in general, be constrained by other mid-sized stores within 5-10 minutes drive-time and by larger stores within a 10-15 minute drive time.
    - Convenience stores will, in general, be constrained by other convenience stores within approximately half a mile, by mid-sized stores within a 5-10 minute drive-time and by larger grocery stores within a 10-15 minute drive-time. (p.256-7)

- There are a significant number of stores in both the large grocery store product market, and the mid-sized and larger store product market, that operate in areas of high concentration (p.257)

- Weak competition in local markets ….influences the retail offer of grocery retailers operating in those markets in two ways. First it provides national or regional grocery retailers….the ability to weaken those components of the retail offer, such as prices,….Second, in those local markets where competition is weak, a grocery retailer can degrade components of the retail offer, such as product range and quality, on a store specific basis. In relation to this second effect we estimate that for an average larger grocery store, this would translate into a profit increase of £20,000 to £25,000 per month. (p.258)

- The persistence of areas of high concentration of grocery retailing over the past five years indicates the existence of barriers to entry and expansion in grocery retailing for both larger grocery stores and mid-sized grocery stores, (p.258)
- In relation to cost advantages, we consider that the national grocery retailers have a cost advantage over their smaller competitors as a result of their distribution systems, and these may represent a barrier to entry ….however we consider that this cost advantage is mitigated by the presence of the wholesaling sector. (p.259)
- ….the planning system may also, unintentionally create barriers to entry or expansion that are not necessary for the overall objectives of the planning system. (p.259)
- The four largest grocery retailers together own approximately 520 landbank sites as well as controlling at least a further 366 sites through leases to third parties, restrictive covenants and exclusivity arrangements….(p.260)
- In a significant number of cases, however, the land holdings of grocery retailers…represent a means by which entry by competing retailers into local markets may be frustrated. (p.260)
- The three conditions for tacit coordination to emerge and be sustainable are all present in grocery retailing….(p.262)
- We have identified a trend of consolidation among upstream intermediaries in milk and other sectors…..Further consolidation may be a cause for concern… (p.263)
- We also consider that category management is capable of facilitating coordination between retailers… (p.263)
- We consider that all grocery retailers and wholesalers, in certain circumstances, able to exercise buyer power in relation to at least some of their suppliers. The largest grocery retailers, given their size, will have buyer power in relation to more of their suppliers than smaller grocery retailers and wholesalers… (p.263)
- In relation to UK primary producers ….we consider that the buyer power of grocery retailers and their intermediaries is one of a range of factors that has influenced farming profitability in recent years. (p.264)

8. PLANNING ISSUES IN AUSTRALIA

The UK Competition Commission's interim report on its grocery market inquiry underscored the impact of town planning processes on competition. Various remedies, including divestitures, are being considered there.

In Australia, the division of responsibilities across a three-tiered system of government makes the task very difficult, but planning issues need to be addressed to prevent the further consolidation of local markets into duopolies or monopolies.

A recent development in Hurstville, New South Wales, illustrates the problem. The Westfield shopping centre in Hurstville has a Coles supermarket, an Aldi store and a Woolworths *Food for Less.*

Across the street, retail space at Hurstville railway station was refurbished. Coles now operates a supermarket there of about 3000 square metres, about 100 metres from the Coles store in the Westfield centre. Coles was already the dominant supermarket operator in the local market and has now ensured that a new competitor is unlikely to enter that market.

One might argue that in an ideal world either Coles would have been required to divest its existing store before opening the new one, or that a similar open/divest opportunity was given to a competitor so that the local market remained competitive rather than dominated by one player.

We recognise that the town planning regime involves multiple objectives and we recognise that competition issues are not generally considered by State or local government planning authorities.

But, as in the United Kingdom, competition in local markets suffers if some form of public interest test is not applied at the point where a pro-competition result can potentially be achieved during the planning/leasing process. If no such intervention occurs, a dominated local market might then be established for the indefinite future.

We ask the ACCC to consider whether an amendment to the *Trade Practices Act* requiring competition issues to be considered at State and local government level might achieve greater competition in local markets, perhaps by a requirement that a development application in any market sector designated by the Commission, say grocery retailing, must be subject to a competition or public interest test specified or approved by the ACCC.

A mechanism by which such a pro-competitive result might be achieved, we suggest, might be to include conditions in development applications to prohibit a new retail space to be operated by a designated corporate entity which is already represented in that local market. The shopping centre operator would then be obliged to offer the space to a new competitor. A “designated corporate entity” might be a company with a predetermined market share - say, more than 30 per cent of a State or national market.

A dominant player in a local market would not necessarily be precluded from upgrading to a better or bigger site in the same market, but would be required to divest the original site. This could require a condition on the development application that the divested site would continue to operate as a grocery retail outlet, ensuring that the supermarket chain would actually divest the site, not transfer the site to a related entity - for example, a vacated supermarket site could not be transferred to the same company’s liquor store banner. The Commission might consider whether this could also be achieved through an enforceable undertaking in instances where the DA route was not applicable.

Clearly, the domination of a local market may cumulate to domination of a regional, State or national market when large corporations are involved.

We therefore suggest that such pro-competition planning requirements might best be targeted to designated corporate entities which already have a specified share of a State or national market - say, 30 per cent market share.

Hyper-concentration of the Australian grocery market has occurred in part because of the hyper-concentration of prime retail sites by shopping centre developers. Large shopping centre operators seek large supermarket operators as anchor tenants.

We recognise that such a symbiotic relationship between large shopping centre operators and large supermarket operators exists and that prime sites in large centres deliver large numbers of shoppers to large supermarkets. That is not to say that those shoppers benefit from competition in such centres in every case.

A number of large shopping centres - eight by our count - have featured a Coles supermarket at one end and a Coles-owned Bi Lo at the other, a form of sham competition which is a *de facto* monopoly. Again, the application of a competition test might have precluded such anti-competitive arrangements.

If the power of the shopping centre developer is combined with the power of the dominant supermarket chains, the result is almost certainly continued market share growth and market sharing by the supermarket chains unless some new pro-competition mechanism is introduced to the equation.

9. CREEPING ACQUISITIONS

Woolworths and Coles have had for many years a policy of buying market share when they could not win it through competition. This could alter the overall economies of scale for the independent sector while at the same time increasing the dominance of the supermarket chain duopoly. Economies of scale are essential for grocery retailing. A Woolworths or Coles store or an independent must each be supplied by a wholesale warehouse buying centrally or they would not be viable. The critical mass required to pass through each warehouse may now be upwards of $500 million a year.

While potential acquisition of a large number of retail outlets by a supermarket chain - such as occurred in the Franklins sell down or the sale of Foodland Associated Limited's *Action* stores in Western Australia and Queensland - might attract the attention of the competition regulator, the acquisition of a similar number of stores over a longer period seems to be more readily accepted, even though the end result is identical in terms of acquired market share.

The conceptual difficulty seems to be that the ACCC primarily considers the local market in which a creeping acquisition target operates, rather than "regional, State and national" markets jointly and simultaneously: if the number of players in a local market remains unchanged, then the impact at State and national level is ignored.

As a direct consequence, the State and national market share of Woolworths and Coles has been allowed to increase, enhancing their ability to use market power. There have been a number of high-profile actions, for example, the Safeway bread case penalty in Victoria and the more recent cases of anti-competitive behaviour in the liquor market in

New South Wales, resulting in a judgement against Woolworths and acceptance of a penalty without admissions by Coles.

The hyper-concentration of the Australian grocery market is such that it is, we believe, no longer in the national interest for the process of market concentration to continue.

We do **not** argue that the dominant players should be prohibited in practice from opening new stores or acquiring larger or better sites - or any other form of market 'cap'.

However, a pro-competition principle should be applied in every instance because of the hyper-concentration of the Australian grocery market: not only that there should not be a substantial lessening of competition, but that every opportunity should be taken to enhance competition by encouraging new competitors into any given market and, by corollary, that an existing dominant competitor, should be obliged to loosen that dominant position. The hyper-concentrated Australian retail grocery market is a special case and now requires a special response from legislators and the regulator.

We recommend that if a dominant corporate entity - which might be defined as, say, a company with 30 per cent or more of State or national market share - is involved in any acquisition, then, in recognition of the hyper-concentrated grocery retail market, that acquisition should be the subject of the closest scrutiny and accepted only if pro-competitive off-sets are achievable.

Such off-sets might include, for example, divestiture of an existing retail grocery outlet in the same or a nearby market or divestiture of equivalent value development site(s). Given that a potential acquirer might include the other major supermarket chain, a secondary round of assessment would then be necessary before that player was permitted to acquire the site being divested.

10. PREDATORY PRICING

NARGA acknowledges that the predatory pricing amendment passed by the previous parliament was an important statement of principle - a line in the sand, a warning to large companies that such conduct is not acceptable.

Whether the new provision would survive the legal process is not clear, however.

Any case taken would require that it be proven that the perpetrator had a "substantial share of a market" and had offered "for a sustained period of time" a product or service at a price below the "relevant cost of supplying" it, for the *purpose* of "eliminating of substantially damaging" a competitor, or "preventing or deterring" a competitor from entering a market.

None of which would be easy to prove.

In the context of the ACCC's consideration of the advice it will give government, we draw the Commission's attention to the fact that the predatory pricing provision needs to be revisited with a critical eye. In terms of the time it takes to damage a small business, "a sustained period of time" might be quite short. And if a large company is the beneficiary of price discrimination, below-cost selling might not be necessary.

11. PRICE DISCRIMINATION

Introduction

Price discrimination is **not** about economies of scale. Economies of scale would still apply between supplier and customer, *where appropriate*, if price discrimination were to be prohibited again. We say "where appropriate" to underscore the need to protect consumers and competitors against claims of economies of scale which are no more than subterfuges to disguise price discrimination. In any case, economies of scale are far more limited than might generally be believed and entail serious risks to suppliers, as we shall discuss below.

Not all price discrimination is anti-competitive and therefore not all price discrimination should be proscribed. But anti-competitive price discrimination is about detriment to suppliers, competitors and consumers. If a discriminatory price advantage can be extracted from a supplier by a dominant retailer, it will be. There is little or no likelihood that a competitor can recover the lost ground later in the supply chain, even if he were to accept a lower profit margin.

Anti-competitive price discrimination may arise in a number of ways. In the Australian grocery market it is likely to be in the form of demands from a supermarket chain to a supplier to accept a lower price for a product than the price at which he sells to a competitor wholesaler/retailer or to provide equivalent benefits through bundled terms, such that the supermarket effectively enjoys a pricing advantage at that point in the supply chain. From that point on, the competitive advantage is unlikely to be eroded and the consequences for smaller competitors can be dire.

US Congressman Wright Patman summarised the issue thus:

> *If we had to provide a single statement as to the economic tests of an objectionable price discrimination, we would have to say that it is a discrimination that has a substantial tendency to divide the market shares in ways different from the division that would take place if efficiency were the sold determinant of this question.*[26]

In his evidence to the Senate Economics References Committee's inquiry into *The effectiveness of the* Trade Practices Act 1974 *in protecting small business,* the then Chief Executive Officer of Woolworths, Mr Roger Corbett, AM, illustrated the issue.

Mr Corbett told the Committee:

> *I think where we find some difficulties is where a small operator in a centre, a street or a town reduces their prices below ours. That is okay. They are a little operator and they choose to go below us. But, if we choose to go below them, in some circumstances that could be considered predatory pricing. It is all right to go below a major competitor, but if it is a small competitor our policy is always to match the price and never to go below the price, except where it might be a general special that we are operating in a wider area.*[27]

What he did not tell the Senators was that because Woolworths can use its market power to extract a discriminatory price from a supplier, unrelated to economies of scale, they can then "match" a smaller competitor who has a product on the market below his own buy price (that is, as a loss leader), without actually selling below cost themselves. Such price discrimination may occur in major product categories, such as milk.

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[26] Patman, op. cit., p. 54.
[27] Senate Economic References Committee, *The effectiveness of s.46 of the Trade Practices Act 1974 in protecting small business*, 30 October 2003, *Hansard,* p. E5

According to Mr Corbett, Woolworths would sell below cost to match a competitor's promotional price on a special, but would not sell below cost to damage a smaller competitor.

The issue then becomes one of intent: something like a hunting accident.

As we have seen, advantages flowing to Woolworths and Coles through price discrimination allow them to match or go below a competitor's price without actually going below their own cost. Nevertheless, this remains a form of predation and is recognised in the literature as "above cost predation".

Where no prohibition against price discrimination applies, the end consumer of a product is exposed to unnecessary price increases either through the actions of a large supplier, manufacturer or distributor who is able to impose local price discrimination to eliminate or injure smaller competitors in local markets, or by a large customer who is able exert pressure on a supplier to accept a discriminatory price which would allow that large customer to eliminate or injure its competitors in local, State or national markets. In either case, once such competition is eliminated, consumers are exposed to price increases.

It is quite clear that price discrimination is undertaken with the intention of injuring or destroying competitors - to bring about a substantial lessening of competition in a market. Paths to that objective need to be blocked as soon as possible.

In the Australian grocery industry, a situation of hyper-concentration of the retail market has been allowed to develop, the likes of which occurs nowhere else in the world. That situation exposes all suppliers to the threat of retribution for non-compliance with the demands of two supermarket chains which account for 80 per cent of all sales. Those suppliers are consequently forced to raise prices for other, smaller, customers, who are then effectively cross-subsidising the prices paid by their major chain competitors.

If price discrimination allows a dominant competitor in a hyper-concentrated market to extract an advantage at an early stage of the supply chain, then it is unlikely - probably impossible - that a smaller competitor could recover to a competitive position, even if the smaller competitor were prepared to accept lower margins.

The major supermarket chains are not charities and there is no reason to believe that if the remaining 20 per cent of the Australian market were to fall into their hands they would lower prices. On the contrary, prices would almost certainly rise because competition would be replaced by market sharing.

Without a prohibition on price discrimination, however, competition is effectively hamstrung: suppliers are exposed to intimidation and the threat of retribution for non-compliance with the demands of powerful customers and competitors of those powerful customers are burdened with a price disadvantage from which they are unlikely to recover, even if they accept a lower profit margin.

Price discrimination is particularly damaging in Australia's unique hyper-concentrated grocery market, where two major companies share 80 per cent of sales nationally.

It is important to understand that price discrimination prohibitions, as applied internationally, would catch both the supplier and the customer involved in such a transaction.

The corollary is that price discrimination legislation strengthens the position of a supplier, who can thus resist demands from a large customer for discriminatory favours, using the legislation as a shield.

Price discrimination prohibitions: Australia in the international context

Australia previously had prohibitions on price discrimination through s49 of the *Trade Practices Act 1974*, as follows:

> ***SECTION 49 PRICE DISCRIMINATION***
>
> ***49(1) [Prohibited conduct]*** *A corporation shall not, in trade or commerce, discriminate between purchasers of goods of like grade and quality in relation to:*
>
> *(a) the prices charged for goods;*
> *(b) any discounts, allowances, rebates or credits given or allowed in relation to the supply of goods;*
> *(c) the provision of services in respect of the goods; or*
> *(d) the making of payments for services provided in respect of the goods;*
>
> *if the discrimination is of such magnitude or is of such a recurring or systematic character that it has or is likely to have the effect of substantially lessening competition in a market for goods, being a*

market in which the corporation supplies, or those persons supply, goods.

49(2) [Certain price discrimination not prohibited] *Subsection (1) does not apply in relation to a discrimination if**:***

(a) the discrimination makes only reasonable allowance for differences in the cost or likely cost of manufacture, distribution, sale or delivery resulting from the differing places to which, methods by which or quantities in which the goods are supplied to the purchasers; or

(b) the discrimination is constituted by the doing of an act in good faith to meet a price or benefit offered by a competitor of the supplier.

49(3) [Onus of establishing subsec (1) does not apply] *In any proceeding for a contravention of subsection (1), the onus of establishing that the subsection does not apply in relation to a discrimination by reason of subsection(2) is on the party asserting that subsection (1) does not apply.*

49(4) [Attempts to induce or to enter transaction to obtain benefit of prohibited conduct prohibited] *A person shall not, in trade or commerce:*

(a) knowingly induce or attempt to induce a corporation to discriminate in a manner prohibited by subsection (1); or

(b) enter into any transaction that to his knowledge would result in his receiving the benefit of a discrimination that is prohibited by that subsection.

49(5) [Defence to prosecution under subsec (4)] *In any proceeding against a person for a contravention of subsection (4), it is a defence that if that person establishes that he reasonably believed that, by reason of subsection (2), the discrimination concerned was not prohibited by subsection (1).*

Section 49 was repealed following the recommendations of the Hilmer Report in 1993, which argued:

> *The provision* [s49] *is contrary to the objective of economic efficiency and has not been of assistance to small businesses.*

The statement is incorrect: governments routinely regulate across all policy areas in ways that do not give over-riding precedence to considerations of "economic efficiency".

"Economic efficiency" *per se* has never been an over-riding policy goal of any government. Indeed, economic efficiency is often sacrificed for political purposes: proposed phase-out of lightweight plastic shopping bags, costed by the Productivity Commission at $1.3 billion, is a case in point; banning or restricting display of legal tobacco products is another.

There is a clear benefit to small businesses in being able to source product at or near the prices paid by the supermarket chains and to customers in being able to pay similar prices for key product lines no matter where they choose to shop.

In the context of the continued hyper-concentration of the Australian grocery market in the years since, the Hilmer report's views on price discrimination look dated and misguided and probably tendentious, accepting as it does the argument that "suppliers will be prevented from granting discounts to purchasers with large requirements such as grocery chains in the absence of cost justification",[28] which is simply beside the point, since price justification can be anticipated and provided if genuine. This specious argument was echoed more recently in Woolworths' response to the 2007 amendment to the predatory pricing provisions of the *Trade Practices Act* - that it would need "an army of lawyers to discount bread on a Saturday afternoon".

In any case, Hilmer's quaint belief that "price discrimination generally enhances economic efficiency" and should not be allowed to provide special protection to any interest group, including small business, to the detriment of the welfare of the community as a whole remains remarkably unsubstantiated fifteen years later.

One wonders why providing an anti-competitive benefit - price discrimination - to an intimidatory dominant player could have been seen as in the public interest, while protecting smaller businesses - suppliers or competitors - from anti-competitive conduct by much larger players was not. This is robber baron economics.

[28] *National Competition Policy, Report by the Independent Committee of Inquiry,* August 1993, quoting Corones, S. G., *"Competition Law and Policy in Australia"* (1990) at p. 78.

Repeal of s49 has left Australia at odds with the legislative shields available in the United Kingdom, the United States, the European Union and Canada:

- Chapter 1 of the Act and Article 81 of the EC Treaty prohibit agreements between businesses that prevent, restrict or distort competition or are intended to do so and which affect trade in the UK and/or EU.

  Agreements likely to be prohibited include those which:
  - Fix the prices to be charged for goods or services
  - Limit production
  - Carve up markets
  - Discriminate, eg, between customers (eg, charge different prices or impose different terms where there is no difference in what is being supplied).

- Section 2 of the UK *Competition Act 1998* is similar:

  Agreements etc. preventing, restricting or distorting competition

  2. - (1) Subject to section 3, agreements between undertakings, decisions by associations of undertakings or concerted practices which –

  (a) may affect trade within the United Kingdom, and
  (b) have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom, are prohibited unless they are exempt in accordance with the provisions of this Part.

  (2) Subsection (1) applies, in particular, to agreements, decisions or practices which –

  (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
  (b) limit or control production, markets, technical development or investment;
  (c) share markets or sources of supply;

> (d) *apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;*
> (e) *make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.*
>
> *(3) Subsection (1) applies only if the agreement, decision or practice is, or is intended to be, implemented in the United Kingdom.*

And in the United States, a Congressional committee reporting on the Patman bill, then before the House of Representatives, said that price discrimination practices had the effect "*…that the survival of independent merchants, manufacturers, and other businessmen is seriously imperiled* [sic] *and that remedial legislation is necessary*."

Anti-price discrimination legislation in the United States has been hailed by small business and the general public, but opposed by big businesses, the major perpetrators and beneficiaries of price discrimination.

Wright Patman, one of the co-authors of the US legislation, has also noted that:

> *In many instances, big buyers were demanding special price concessions and coercing small suppliers into granting special concessions with threats of putting up their own manufacturing plants. In other instances, they were playing the suppliers off against one another, forcing suppliers of nationally advertised products to meet the prices of small, exclusive suppliers who could not, in practice, market to the independent trade.*[29]

Subsection 2(a) of the Robinson-Patman Act consequently provided:

> *Sec. 2(a) That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the*

[29] Patman, W., *Complete Guide to the Robinson-Patman Act*, Prentice-Hall, Englewood Cliffs, NJ, 1938, 1963, p8

purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or in any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line or commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.

The similarities between the UK, US and EU legislation and the now-repealed Australian legislation are obvious.

Australia's current egregious position of having no such prohibition needs to be addressed.

NARGA recommends that the former s49 of the *Trade Practices Act 1974* be reinstated or that a similar prohibition be included among proposed amendments to s46 (misuse of market power) to bring Australian into line with international practice.

The Hilmer report argued in 1993 that s49 was unnecessary because s45 (anti-competitive agreements) and s46 (misuse of market power) would catch any such behaviour which resulted in a substantial lessening of competition in a market. It was an empty claim at that time and so it proved when the High Court handed down its decision in *Boral Besser Masonry Ltd v ACCC* (the *Boral* case), rendering s46 ineffectual. No cases have been taken under s46 since that decision.

It is important to note the High Court's view in the *Boral* case that a corporation did not have market power (and therefore could not misuse market power) unless it could raise prices unilaterally without losing market share. Many would now consider that the major supermarket companies are in just such a position through their enormous cash resources, their domination of large prime sites, the potential for cross-corporation subsidy, their domination of a hyper-concentrated market and their market power *vis a vis* suppliers, competitors and customers alike - that they can and do raise prices unilaterally without losing market share.

Economies of scale are not unlimited

Some people regard anti-price discrimination provisions as being attacks on the benefits which large players can achieve through economies of scale. This is not correct.

Patman has described the limits of economies of scale and they are worth noting in case anyone should believe that such benefits are indefinitely available:

> *The law of diminishing returns applies to quantity discounts, as it does to taxes or any other comparable factor. Up to a certain point, volume business from a single buyer is inviting and generally deemed profitable. There are pronounced savings in cost involved. As an illustration, the business of a retailer is usually considered unprofitable if he only purchases occasionally and in broken lots. On the other hand, a retailer who buys with reasonable regularity and in standard quantities is accepted as a profitable dealer. Usually, the volume that a retailer buys in most lines of commerce need not be extremely great in order to reach a peak in efficiency and low cost of handling. From that point on, there is no appreciable savings in cost, though the added volume per dealer has an intrinsic and sometimes intangible value to the seller, which is expressed in a reward of 1, 2, or 3 per cent additional discount as the volume increases. Such rewards, however, do not ordinarily result in injurious discrimination among competitors.*
>
> *On the other hand, volume purchases may attain a size where they become disadvantageous, if not dangerous to the interests of the seller. Most manufacturers, in the past, have always sought to diversity their outlets and to avoid selling too large a share of their production to any one purchaser. To do so was to invite, sooner or later, the domination of one's business by the single large purchaser: (1) The single large purchaser demanded more and more concessions; profits were reduced or vanished; the manufacturer's other customers could not compete with the large purchaser, and he lost those channels of distribution, placing him solely at the mercy of the single large purchaser; or (2) before that complete state of affairs was reached, the large-volume purchaser switched to a new source of supply and left the manufacturer high and dry. In any case, if a manufacturer permitted too much of his business to go to the hands of a single large buyer, he often invited ultimate bankruptcy and failure.*
>
> *Therefore, while the business of a reasonable-volume buyer was inviting and at the same time demonstrated economic savings in cost, that volume soon reached a point where there was no further savings in cost regardless of how great the volume*

became; that is, the law of diminishing returns came into play. So the above dealer has more or less correctly sized up the fallacies of quantity discounts and prices. If one were to chart the cost factor in the handling of consumer goods, he would find a similarity of experience in nearly all kinds of goods: Beginning with a single article, his cost per unit would decline rapidly as quantities increased. It would soon approach a point, however, where his chart line would level off, and from there on decline imperceptibly, if at all, as the quantity unit increased in size. In many cases, the per-unit cost factor may rise as the bulk unit is increased.

The comments above underscore the threats and risks inherent in a hyper-concentrated market such as now pertains in the Australian grocery industry.

In evidence to the ACCC's Petrol Price Inquiry, Caltex admitted they were now supplying as much petrol to Woolworths-operated service stations as they were selling through their own sites. Shell is in a similar relationship with Coles. Each is now just another supplier to one or other of the grocery duopoly and are now exposed to the supermarket chains' power in both grocery and petrol sectors

All major suppliers to the supermarket chains are in this situation because the Australian grocery market is hyper-concentrated. We predict few suppliers will voluntarily appear before the Grocery Pricing Inquiry to give evidence under oath because they are intimidated and fear retribution.

12. EXCLUSIVE DEALING

Exclusive dealing in trade practices terms refers to practices that impose some restriction on one of the parties in a transaction to choose what is purchased from whom, or the conditions under which the transaction takes place, or which are aimed to exclude other parties from similar transactions.

Some types of exclusive dealing are prohibited outright whilst other types are reviewed on the basis of whether they result in a 'lessening of competition', and allowed if they are not seen as such.

Third line forcing – where a product is sold on the condition that another product is purchased, or a discount is given on the condition of another unrelated purchase, is prohibited under the Trade Practices Act. However, the ACCC may grant permission for such activity if it is seen to be in the public interest and not seen as lessening competition in the affected sectors. The petrol 'Shopper Docket' schemes are an example - although it will be argued that the ACCC got it wrong in this case, as the schemes run by the major chains are clearly anti-competitive and result in a reduction of net consumer welfare.

However, changes to the *Trade Practices Act* that came into effect in January 2007 mean that 'related companies' are seen as a single entity under the act and so are not affected by 'third line forcing' prohibitions.

Product 'bundling' – i.e. the supply of product in multiples or in useful combinations – is a form of exclusive dealing common in the grocery sector, but is not usually regarded as anti-competitive.

The types of exclusive dealing that can be anti-competitive include:

- Refusal to supply a product to a particular party
- Supply or purchase conditional on non-related factors
- Market share discounts that advantage a key customer
- Exclusive contracts – e.g. exclusive purchase arrangements
- Certain forms of promotional payment
- Certain types of 'loyalty rebates'
- Pricing barriers

Exclusive dealing practices can be 'horizontal' as well as 'vertical' – depending on whether the practice targets an upstream or downstream rival entity. They can include, for example, a dominant company trying to exclude a rival firm from its supply chain by blocking or restricting access to supply of certain goods, or by 'disciplining' a supplier for dealing with a rival, or providing equivalent terms.

If the activity in question has an anti-competitive effect, it can be considered illegal.

It could be argued that the provision of a certain product pack size exclusively to one of the major chains, for example, is anti-competitive if it places another competing retailer at a competitive disadvantage – because that retailer is prevented from offering his customers the same benefit.

A wide range of practices within the grocery supply chain involve a form of exclusivity. ACCC has, to date, not examined these practices to determine their effect on competition.

13. COLLUSION

Cartel behaviour is a hard form of collusion that is clearly illegal under the *Trade Practices Act*. There are however several ways in which collusion can occur to the detriment of competition in the sector which have not received the attention of the ACCC.

One form of tacit collusion is parallel pricing – where the prices for a product or range of products between two rival companies are the same or similar with the result that consumers see them as basically offering the same price benefit. Such reduction of competition in the sector results in market sharing. This benefits both parties, eliminating the need to compete on price.

One possible example is the Petrol Shopper Docket schemes operated by both major chains. Both offer a four cent discount which has remained unchanged since the schemes were started. This obviates the need for direct competition in the discounting of petrol. It could also be argued that the existence of the schemes obviates the need to discount petrol – or to compete on price. The result is that prices in the sector are higher than they would have been in a fully competitive environment.

Another form of collusion is 'vertical' in nature. In this case larger suppliers to the major chains consciously or unconsciously act together to supply product in a manner that protects the margins of both retailer and supplier from competitive pressure. In this scenario we see the chains applying the usual pressure to suppliers to reduce prices and / or give the chain a greater share of the total available margin. A larger supplier can respond by raising prices to both of the major chains to protect margins. Given that the major chains control 80% of the grocery market, the supplier is guaranteed no reduction in sales will occur. The result is a net increase in price to consumers.

It is clear that the two major chains carefully monitor each other's prices over a wide range of products. There are several reasons why they should do this – and not all of them related to giving their customers the 'best prices'.

It should be recognised that both of the major supermarket chains essentially provide the same product offering – a one stop grocery store with a wide range of 'fresh' product at 'low' prices (the 'fresh' and 'low' image being reinforced through advertising.) Under such circumstances it is important for each chain to 'price match' on the key elements of the range and to ensure that across the board they are getting at least the same deal from their suppliers. Price checking provides the necessary signals.

However, price checking can also provide another function – monitoring and mirroring each other's price increases to provide an assurance that these increases can be sustained.

This form of tacit collusion is obviously anti-competitive.

14. UNIT PRICING

Proponents of unit pricing assume, wrongly, that unit price allows direct and useful comparison between two products. It does not. Oils ain't oils - take olive oil as an example of a category where many varieties are available in standard packs, but prices vary significantly according to quality.

If a shopper's sole or major criterion in purchasing a product is price, then that shopper is - by definition - most likely to choose the cheapest item on the shelf, probably a generic. The unit price therefore would be irrelevant.

Unit price comparison between other products discounts the real and long documented preferences of consumers as expressed in purchase patterns. Such decisions are influenced by brand loyalty, quality, preparedness to try innovative products, experience and peer recommendations.

The shelf price ticket thus provides a "summary" of the various components of the value equation expressed as a price. Unit pricing expresses only the price component of the value equation.

As price is only one of the variables affecting product choice, the only valid use of unit pricing is for comparison between two different sizes of the same brand of product. A different brand would have a different formula and different characteristics or may be different in quality, or imported and subject to currency fluctuations.

Product quality is a key determinant of the purchase decision, and consumers tend to rely on their own experience and that of family and friends, as well as the brand's reputation, to decide the relative quality of a product.

A unit pricing regime can therefore result in downward pressure being placed on product quality – a race to the bottom.

Price is only one issue shoppers consider in their purchasing decision and many years of research have marked it as a lower level concern.

In some categories, price plays a minor role: most people have their personal favourite brand of shampoo, for example, and would buy it almost without regard for price.

Unit pricing is already available on goods packed in-store, e.g., fruit and vegetables, meat, delicatessen items, etc.

Australia's packaged grocery sector uses a range of standardised pack sizes as a result of an earlier regulatory requirement. This legislation had a similar intent to that of unit pricing, but was repealed in the early 1990s in the belief that it was overly restrictive and not adding consumer benefit. It also narrowed choice and reduced competition by preventing the sale of imported product in non-standard sizes.

15. ANSWERS TO ACCC *ISSUES PAPER* QUESTIONS

Question 1: What have been the major causes of rising food prices in Australia? In particular, what have been the major causes of the rising prices of products such as milk, cheese, bread, fruit and vegetables?

The major cause of the rise of retail prices for food in Australia has been that food manufacturers and food processors have been passing on increased in prices to retailers.

In the case of milk, independent retailers in WA are now being charged up to 50c a unit for 2ltr of milk, an increase of 26% in the last 9 months.

In most cases the independent retailers continue to work on a gross margin of around 20%.

The supermarket chains continue to have their house brand milk supplied at a lower price than the branded milk available to independents.

Perhaps this is adding to the pressure on processors to put up the price of their branded milk in an effort to recover some margin from other retailers and therefore consumers. This may be the waterbed effect on prices that has been referred to by the UK Competition Commission.

It would also seem that increases in wholesale prices are not being passed onto farmers in full as they remain concerned about the long term viability of their farms.

In the case of bread, we have seen increases up to 20c per loaf by the major bakeries, a 15% increase in cost in the last six months.

Fruit and vegetables have had normal fluctuations in price with a recent shortage due to high temperatures keeping prices of some lines high after early summer trade.

For a lot of lines, however, we are finding that we are paying the same or similar to last year's wholesale prices and this is reflected in stable retail prices. There is currently a shortage of last season apples that is keeping the price of new season apples high. However, industry sources predict prices will come down to normal when picking is completed.

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

International comparisons are not always valid in detail because of statistical collection variations from place to place. However, the "big picture" trend lines do tell a story and illustrate key points - in this case, that Woolworths and Coles are the price setters for the Australian market and the prices paid here are consistently above all international trends.

Question 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 to the structure of the grocery industry over the last 15 to 20 years has been the growth in market share of the two major chains to now nearly 80%. This has given the chains dominance over their suppliers.

Question 4: What factors have driven these changes?

Acquisitions of independent businesses by the supermarket chains has been one of the main driving factors of this growth in market share combined with the major chains ability to secure prime sites for new stores in major shopping centres. Such sites have not been offered to independents.

Trading hours changes have also delivered market share to the supermarket chains at the expense of independent businesses.

Question 5: How important are economies of density, scale and scope in grocery retailing?

Economies of scale are a necessity for grocery retailing. The MSCs and independents must all be supplied from central warehouses or they would not be able to trade. Estimates previously given to the ACCC are that the critical mass of supply has to be above $350 to $400 million a year from each warehouse location to remain competitive and in business. This figure may now be upwards of $500 million a year.

Question 6: What are the most appropriate ways of measuring the shares of grocery retailers?...

The industry has used ACNeilson data for many years and it is still readily accepted by all retailers, manufacturers and suppliers in the day to day running of their businesses.

As percentage of sales of other departments in supermarkets tend to be the same or very similar it is also logical that fruit and vegetables, meat, deli departments etc would also be the same. For example, as the chains have (at least) 79% of the dry goods market sold to all supermarkets they would also account for a similar percentage of sales for all whole milk sold to supermarkets, the same percentage for fruit and vegetables, meat, etc.

Each of these supply chains have other categories of customers as do the dry goods grocery manufacturers.

As an example, food service companies are supplied by major food manufacturers but buy in different pack sizes, different quantities, etc. and are there fore not included in the suppliers grocery channel.

Question 7: Provide detail of recent entry and exit in grocery retailing

These issues have been well documented with the sale of Franklins, entry of Aldi, takeover of FAL and subsequent sale of *Action* stores.

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

Due to the necessity of buying through a central warehouse, the issue of transport to rural and regional areas is the main concern combined with the lack of service providers in these areas.

The majority of rural Australia is serviced by the independent sector as the MSCs cannot get the critical mass from these areas to make it worth their while. Failure of the non-chain sector would see large areas of Australia without any distribution system.

Question 9: How profitable are grocery retailers? What margins over wholesale costs do grocery retailers achieve? …

Independent grocery retailers are in the main profitable, however, there are many variables including the structure and overheads of each individual business.

Margins and profitability of independents do not necessarily differ depending on the size or location of the store. They are more likely to differ depending on the product mix of the sales of the store.

For example some stores may have a high percentage of low margin tobacco sales with little or no high margin specialty foods or a low percentage of fresh fruit and vegetables.

This mix of sales is the greatest factor determining the overall margin of the business.

In regard to rate of return most independent supermarkets will trade for between five and six times EBIT.

Profit margins in some independent stores have increased over the last 15 years with a lot more emphasis being placed on fresh offers which will increase the percentage of higher margin sales.

Rates of return have increased in accordance with the rise in profit.

This is not the case in many independents stores which have had sales in line with percentages achieved by the MSCs, case in point Western Australia.

Grocery wholesaling

Question 10: What have been the major changes to the structure of grocery wholesaling over the past five to ten years?

This has been well documented, with rationalisation of the independent wholesale market to where there is a major independent supplier IGA Distribution, and smaller wholesale operations by Franklins in NSW, SPAR in Queensland, and ALDI supplying their own stores with a limited range (some 600 lines).

During the early 1990s the Australian grocery wholesaling sector also went through a period of market consolidation, driven by a desire to develop a larger "third force" in the grocery industry. Until that occurred, the more numerous but much smaller grocery wholesalers did not benefit as much from economies of scale and their retail customers were consequently exposed.

Question 11: What factors have driven these changes?...

The main driving factor has been the need to have sales volumes through a single independent warehouse in each state to compete with the MSCs. buying power and deliver the same economies of scale to the independent sector.

Question 12: In what ways does grocery wholesaling differ by category?

There are a number of different wholesale operations in the grocery field with some of these channels servicing the majors as well as independents - for example, bread.

Dry goods groceries are handled through a central distribution centre as are frozen and chilled items.

Even though the IGAD warehouse is vital for the economical supply of goods to the independent sector, in some instances this supply channel may be supplying less than 50% of what the store sells, the remainder being sourced directly by the store.

Question 13: How important are economies of scale in grocery wholesaling?

Economies of scale are vital to the sale of groceries in Australia and take in all aspects of those economies.

Q14 Covered previously.

Q15 Covered previously.

Question 16: How profitable are grocery wholesalers?...

As previously stated, there are many wholesalers of grocery in Australia.

As an organisation representing independent retailers, we are not qualified to comment on profitability of wholesalers, but note that in many instances it would cost the same to deliver to all stores either major or large independent, eg delivery of bread.

It must cost the bakery the same to deliver 200 loaves of bread to any store in the same suburb. We also note that there is a cost (and profit) associated with the running of the MSCs distribution centre in each State, just as there would be with IGA Distribution.

Question 17: Identify each step in the supply chain from suppler to retailer

As there are many supply chains, it is difficult to generalise, but in the case of the majority of branded grocery food products which are manufactured in Australia it starts at the farmer, is transported to a processor or manufacturer who may make the finished product (eg, canned tomatoes) or may be in the first instance an ingredient of the product (eg, sugar) then further transport and further manufacture or processing depending on the product. This could occur several times, as the original product (eg, milk) could be a component of a component of the finished product.

The product is then transported in some instances to the distribution centre of the relevant retail outlet where a cost is incurred to store the product, pick it as part of an order and deliver it to the retail store.

Of course in other cases, such as bread, which has a number of components, the product never goes through a distribution centre but is delivered straight to the retail store.

A similar set of steps can take place in non-food grocery items and in some cases imported components would be used to varying degree as components of the finished product.

The supply of fruit and vegetables is in some cases less complicated, but of course can include imported product, overseas agents, etc., etc.

Fresh meat and processed meats for the deli are different again.

Question 18: Value added at each step in supply chain?...

There are hundreds of activities undertaken in the supply of products to grocery stores with a different value added in each activity.

These would include packaging, advertising, marketing, van sales, etc.

Question 19: Businesses or business types undertaking each activity?...

The businesses that undertake these activities include everything from a one man band cooking cakes or specialty breads to multi national companies overseas supplying ingredients or semi finished product to large or small manufacturers in Australia.

It includes giant dairy processors such as National Foods and niche manufacturers such as King Island Dairy or The Margaret River Cheese Company.

It changes state by state and region by region and would be made up of many thousands of businesses.

Question 20: The pricing structure in each step?...

One could take a specific product and follow it from paddock to consumer plate, but that would not necessarily be indicative of the total industry.

Question 21: Proportion of final retail price accounted for by each part of the supply chain?...

Unable to answer in a way that would prove to be of any use, as there would no doubt be thousands of different variations.

Consumer behaviour

Question 22: What options or choices of retailer do consumers have to purchase grocery products?...

Consumers have the option or choice to buy a can of coke from thousands of different outlets, from supermarkets of 5,000m^2 plus to convenience stores of 80m^2, sometimes owned by the same entity.

However consumers cannot buy all their grocery needs from the convenience stare, just as they cannot from ALDI.

In some instances, consumers who purchase the bulk of their requirements from Coles or Woolworths will have to go to an independent store to buy a specific brand or product that the majors have discontinued. This is quite common and has resulted in Woolworths announcing a strategy to try to change their ranging to be more store-specific. However if a customer asks a Coles or Woolworths store to stock a particular product easily available elsewhere quite often they are told it cannot be done.

Consumers travel different distances in relation to the number of outlets. In Perth, recent research showed the average distance travelled in the metro area was 3.4km. We would think that an impossibility in Sydney.

Consumers' desire is to shop more often and spend less on each shop than before. Refer Fig. 2.12, p.15, *The economic contribution of small and medium-sized grocery retailers to the Australian economy, with a particular focus on Western Australia,* PricewaterhouseCoopers, 2007.

Question 23: Would unit pricing improve the ability for customers to prepare prices?

There is no demand for unit pricing from the general public. Retailers with many years experience in the industry, encountering tens of thousands of customers a year, would report that they have had few, if any, requests for unit pricing. When such requests do occur, a retailer can easily do the calculation on the spot for the customer using a calculator.

If there were sufficient demand for a specific product, a retailer would stock it.

If sufficient customers asked for unit pricing, retailers would do it. Customers do not seek it.

If a customer's sole or main reason for a purchasing decision is price, he or she will almost certainly buy the cheapest product in the category - most likely a generic product or house brand.

Most people do not base their purchasing decision solely or even mainly on price, let alone on unit price, and that statement is based on many years of published research.

How could unit pricing possibly lower the cost of shopping for customers?

People buy 600ml of milk because if they bought 3ltr of milk they would throw the majority of it out. It would be a false economy for a person living alone to buy 3ltr of milk because most of it would be thrown out after the use-by date, regardless of the difference in unit price.

Unit pricing also assumes that the units being compared are identical, that the comparison is like with like. That is not necessarily the case. One might be imported or include imported ingredients, subject to currency fluctuations, for example, or quality might vary significantly between brands or even between generics.

Question 24: How important is range?...

This is the single reason why the volumes of product go through these outlets. If customers were not interested in range, there would not be a range, but a single product in each category.

Question 25: How important is price?...

Research has consistently found that price in general is the fourth- or fifth-level reason for choosing a place to buy groceries. However, all retailers know that if you are not on the money, they will not survive. Just ask Coles.

Question 26: How important are factors such as distance, freshness, product range…?...

These are the reasons that are ahead of price for choosing a place to buy groceries. However, if the only outlet in your town or in your area sells low quality perishables, what do you do?

Question 27: How do consumers gain information on the pricing of grocery retailers…?...

The hundreds of millions of dollars spent on advertising weekly specials at low prices must mean that all retailers see this as the main game to convince consumers to come to them,

Pricing Strategies of Retailers

Question 28: What strategies do grocery retailers use to signal their price offers to consumers?...

All media are used - TV press radio and catalogues. I would think each of the retailer participants in the market is too scared to pull out of one of these activities in case it is the one that works. In other words I do not think they know for sure.

Question 29: How do retailers compare their prices with those of others?...

Price checks are done weekly over a range of products and each of the three groups (two chains, independents) will try to match the other.

However this does not apply in all cases. A NARGA price check showed that a large Woolworths store in Sydney with five times the floor space and eight times the turnover of an independent in WA was 4.74% more expensive on a basket of 13 basic grocery items. Each of the items was a brand leader in its category. A Coles store of similar size to the Woolworths in Sydney was 6.3% more expensive.

Woolworths and Coles stores in Perth were selling the items at the same price as the independent.

Question 30: How effective are shopper docket schemes..?

Shopper docket schemes do not seem to be as effective today as when first introduced, but we note at least one chain is looking to re-launch their scheme and offer a bigger incentive.

However their use by the major chains appears to have resulted in the demise of a significant number of independent petrol retailers and supported further market domination of the total retail sector by the supermarket majors.

Competition in Grocery Retailing

Question 31: Does the nature of competition in grocery retailing differ across product groups?...

Competition differs by way of price sensitive lines such as the staples, perishable lines and quality of fresh produce.

Shoppers doing a weekly shop will tend to be more influenced by price than those doing a top up shop, especially in markets with a limited number of competitors (eg Sydney, where the chains have greater market share than the national average). Range, quality and price are the most important factors in each product group.

Question 32: Who are the major competitors to the MSCs in each product group?

The major competitors are independent supermarkets, convenience stores and specialist retailers.

Question 33: To what degree do Coles and Woolworths compete against each other?...

The more options, the greater the competition and the lower the prices. Refer to prices quoted of Sydney v Perth. The MSCs have said on many occasions that they will match smaller independents and specialty stores so obviously those retail outlets have a great effect on the MSCs pricing.

Question 34: Has the move by Coles and Woolworths into petrol retailing…altered competition…?

Yes it has, but as previously stated the petrol dockets seem to have lost the initial appeal.

Question 35: What are the grocery pricing policies of the MSCs…?...

The MSCs pricing policy seems to be that they will charge what they feel the market will bare in various stores.

Again we cannot understand why their policy would differ in metro Sydney from metro Perth if it was not driven by the need to keep prices lower due to the high presence of independents.

We are not aware of any pricing flexibility given in individual stores by the MSCs and logic would say that they could not as it could easily get out of hand and do them more harm than good.

In the case of the independent sector the only time prices are the same is on advertised lines. In all other cases it is up to the individual owner to price each item as they wish. Guidelines for various pricing is made available however these can easily be overridden at each store and are in a lot of cases put even lower. For example, Cadbury block chocolate with a shelf price of $4.29 constantly overridden at $3.99.

Chains will respond to local independents and specialty retailers at a local level with support from head office.

Question 36: To what degree do grocery prices differ between metropolitan, regional and country areas…?...

Most grocery prices differ between metropolitan, regional and country areas by an amount equal to the cost of freight and extra overheads depending on the degree of isolation. This does differ by product group in the case of independents as they may be able to source local product at a cheaper price than even the MSCs, eg, locally grown fruit and vegetables or a local small bakery.

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

As Coles and Woolworths have close to 80% of the packaged grocery market it would be impossible for any competitor to attain the same size market share without buying some of their business.

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

If this question relates to the previous question, a new player would have to buy one third of each of their business or all independent stores. Alternatively obtain 700 new sites of 3000 square metres plus.

Without either of these steps there is no second step.

If the question relates to a new store start-up in the abstract, a new entrant would need to acquire a site, suppliers, services, fitout, staff and cover compliance costs.

Question 39: Is access to suitable sites a significant impediment to the entry or expansion of supermarket chains?

Coles and Woolworths have been unable to obtain the number of new sites that they announce each year they plan to open, so how could anybody else?

One of the main reasons that Franklins struggled in Australia and ultimately pulled out was because in most cases they were only able to secure the third best site behind Woolworths and Coles.

Some industry people currently argue that one of the reasons for Coles lack of performance compared to Woolworths is because some of their sites on a location basis are not as good as Woolworths, therefore the sales to floor space ratio is lower, therefore the profitability is not as good.

Question 40: Are major shopping centre landlords willing to offer sufficient space to a new supermarket chain?...

No, they are not. There are restrictions (agreed between the landlords and the supermarket chains) against allowing a competitor into some shopping centres, with some agreements restricting a like tenant to a small area, such as under 500 square metres.

Question 41: To what degree are smaller supermarket chains discouraged from expanding…?...

The only thing discouraging a smaller supermarket from expanding is the risk that sales will not go up by enough to cover the extra overhead of the expansion.

Even in the case of the majors, not all costs are recovered in the first year and quite often individual stores may never fully recover all the extra overheads.

When in the case of the independent all costs are not covered quite often it is all of the owners' assets including the family home that go with the bad decision to expand too much.

Competition in grocery wholesaling

Question 42: Are there commercial advantages..of vertical integration…?

Providing the distribution centre of the wholesaler can source product at the same price and run at similar efficiency there is no difference whether the goods are despatched to an owned store or an independent store. Surely if Coles supplies its convenience stores in Shell outlets with small single item pick orders it would cost IGA Distribution a similar amount to deliver the same to a 7-Eleven store.

Question 43: Does the vertical integration of the MSCs impede other players from achieving a competitive scale in grocery wholesaling?

Industry would agree that the impediment to opening a wholesale operation or central distribution centre is the need to have a critical mass to gain the efficiencies needed to run the operation at above cost.

Estimates of this exceed $500 million a year.

Question 44: Can grocery retailers 'bypass' the large grocery wholesalers?...

Grocery retailers whether they are Coles, Woolworths or independents cannot ring up Kellogg and have them deliver some Corn Flakes.

Likewise they cannot ring up their grocery distribution centre and have a loaf of Tip Top bread sent out with their next grocery delivery.

The supply chain differs depending on the product.

As previously stated, independents might buy from IGA Distribution as little as 40% of their requirements or up to 80% - it would ultimately be the individual's choice.

Question 45: What are the impediments to entry into grocery wholesaling?...

Refer to answer to Question 43, re critical mass required to cover overheads.

Buying power in grocery supply markets

Question 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…?...

No doubt Coles and Woolworths use whatever market power they have at their disposal, in what ever way they can, to obtain the lowest possible price from a supplier.

We would expect that if one were a buyer for one of these companies and it was proven that that individual was unable to secure a deal better than the independents, or, heaven forbid, pay more than the independents, that person's job would be on the line. This would apply to all product groups.

Question 47: Do grocery wholesalers or retailers…pass on the lower prices…?

We wouldn't have thought so.

Question 48: Do suppliers incur lower unit costs in supplying larger wholesalers or retailers?...

Freight would be the only difference if there was one, as most of these suppliers have a minimum order quantity.

Question 49: Do suppliers offer the same terms…?...

We wouldn't have thought so.

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

Refer to study by Oxford University economists that shows supermarkets secure 90% of the milk supply chain products, which we believe would be similar in Australia.

Question 51: Do slotting fees reflect the existence of market power?...

Evidence exists of slotting fees that are so high that some manufacturers cannot do business with the MSCs. That is why small companies go to independents to start their business. There a numerous examples of this.

Question 52: Are there other forms of…conduct by supermarkets…that indicate market power?

Many

Question 53: How could wholesalers or retailers exercise any market power?...

Desired brands have been delisted now, regardless of customer preferences. Many suppliers complain about being taken off the shelf to make way for a house brand.

Competitive position of small and independent grocery retailers

Question 54: What are the major sources of competitive advantage…?

The major sources of competitive advantage for small and independent retailers are:
Location
A good location
A convenient location
Product and brand range to suit its customer
Customer service.

Question 55: To what degree do differences in wholesale prices and..terms..affect the competitive position of small and independent retailers?

If an independent retailer cannot source products at a competitive price he has no future.

Question 56: Are the wholesale prices independents pay…affected by the wholesale prices the MSCs pay?...

There is no doubt that the independent sector suffers from the waterbed effect on pricing.

An example is the price increase of 2ltr milk in WA to stores by up to 25% in the last six months, while the supply of house brand milk to the MSCs has not increased by the same. The cost of procurement of the milk and processing of it is the same, branded or house branded.

Question 57: Estimate the differences in wholesale costs faced by small and independent retailers relative to the MSCs

Across the board do not know, but in the case of milk could be a 45% difference in price charged for house brand milk versus the milk that the supplier would like us to sell. No doubt the supplier cannot afford to sell all milk at the lower price so this must be the water bed effect.

Shopper docket schemes

Question 58: What impact have petrol shopper dockets had…?

It seems that shopper dockets no longer have a large effect on customers buying habits.

Question 59: Have independent grocery retailers attempted to introduce their own petrol discount schemes or other discount schemes…?

In WA, independents have a similar scheme of 4c discount for purchases over $25. In a store in Perth with two service stations with in 1km of the store the uptake in one week was 8103 litres at an average fill of 30 litres per transaction that would be 270 customers for that week who took the offer from 9800 total customers or 2.75% of customers. This is on line with the uptake since the introduction of the offer three years ago.

Mergers and acquisitions

Question 60: Have there been acquisitions of independent stores by the MSCs in the pas three years that have not been brought to the ACCC's attention

Do not know.

Question 61: What has been the effect of acquisitions…?

The cumulative effect of acquisitions will ultimately see the demise of the independent sector.

In WA the sector has seen market share fall from 57% to 32% in the last 20 years due primarily to acquisition of independents by either Coles or Woolworths.

If this continues, recognising that there needs to be a critical mass going through a distribution centre to gain economies of scale and there fore competitive pricing, ultimately sales will fall below that threshold and the independent will no longer be able to source product.

This also applies equally to the markets for fruit and vegetables, meat supply, dairy supply etc.

Conduct of grocery retailers

Question 63: Is there evidence of anti-competitive conduct in grocery retailing?...

The independent sector does not attempt to match the MSCs special prices across the board, but let customers take advantage of their own promotional pricing activity.

However it seems fair for the MSCs to match a special buy that an independent store may have obtained even if they were unable to obtain goods at that price.

A simple example may be a store that has been able to buy a special lot of bananas at the market that morning at a special price and retail them for a day or two at below the current expected price. In these cases the major chain will drop the price of their product to match that price and negate the advantage the small store had.

Question 64: Is there evidence of predatory pricing…?

In other cases one of the majors may have a state wide promotion of Coke 2ltr at a special price of $1.99, normally cost, which is advertised through all media at that price. They will then drop the price in a store specific catalogue to $1.89 to target customers from an independent store.

This price even though for a short period is well below the cost to the independent and is only done to adversely impact on that stores business.

If it can sell Coke at $1.89 why doesn't it do it through all stores?

Quite often if it is in a regional or metropolitan area the TV, radio and press ads delivered to the same household as the catalogue will all have Coke at $1.99 while the catalogue is $1.89.

Question 65: Describe such conduct….

Woolworths store in Cootamundra as an example.

Factors influencing the pricing of inputs

Questions 66-72:

Supplier related.

Questions 73-80:

Cost savings in the supply chain to the independent in the main these would be passed straight on to consumers by the individual retailer.

Example of this is retail pricing of milk in WA.

Questions 81-83:

Inclusion of other retailers and major buyers into the code must strengthen the code.