

# WOOLWORTHS LIMITED

A.B.N. 88 000 014 675

14 March 2008

Mr Graeme Samuel  
Chairman  
Australian Competition and Consumer Commission  
GPO Box 520  
Melbourne VIC 3001

Dear Mr Samuel,

**RE: Submission to ACCC Grocery Inquiry by Woolworths Limited on 14 March 2008**

Woolworths Limited is pleased to provide the Commission with this submission to assist it in its inquiry into the competitiveness of retail prices for standard groceries.

Woolworths looks forward to continuing to assist the Commission in its inquiry.

Yours faithfully,



WOOLWORTHS LIMITED  
Peter Horton  
Group General Counsel & Company Secretary



# WOOLWORTHS LIMITED

Woolworths Limited

Public Submission to ACCC Grocery  
Inquiry

14 March 08

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## 1 Executive summary

### 1.1 Introduction

In response to public concern about rising household grocery prices, the Commonwealth Government has required the Australian Competition and Consumer Commission (**ACCC**) to hold an inquiry into the competitiveness of retail prices for standard groceries (**Grocery Price Inquiry**).

The Grocery Price Inquiry is to range widely, assessing the nature of competition at all levels of the grocery supply chain, the competitive position of small and independent retailers, pricing practices and any impediments to efficient pricing. The ACCC's Issues Paper seeks comment on an extensive set of issues.

Woolworths welcomes this opportunity to contribute to a better understanding of the challenges facing Australian food producers and retailers in this time of strong global and domestic cost pressures affecting food products. In view of the extensive set of issues raised, Woolworths is providing a range of information and material to assist the Grocery Price Inquiry.

### 1.2 ACCC Grocery Price Inquiry: Cornerstone Issues

The ACCC has articulated the following cornerstone issues upon which the Grocery Price Inquiry is founded:

- (a) A concern as to whether Australian grocery food prices have increased at a significantly higher rate than the headline inflation rate;
- (b) A concern as to whether Australian food price inflation is higher than in many other industrialised countries;
- (c) A concern as to whether Australia has a highly concentrated grocery industry; and
- (d) On the basis of the above concerns, a resulting concern as to whether Australian retail prices for standard groceries are competitive.

### 1.3 Woolworths' Response to the Cornerstone Issues

- (a) Woolworths' focus

On 26 February 2008, when announcing the Woolworths 2007 – 2008 First Half Year Business Performance, CEO Michael Luscombe said:

*Woolworths remains focused on providing customers with a combination of greater convenience, freshness, quality, range and consistently competitive prices across all divisions and these core values will underpin the broad range of growth initiatives currently underway.*

Woolworths is able to give this commitment to its customers, shareholders and employees during this period of inflationary cost pressures affecting food products due to its five years of investment in supply chain, logistics and buying improvements. The resulting productivity gains and cost of doing business savings have enabled Woolworths to moderate the cost pressures upon its Australian Supermarkets business.

- (b) Rising costs pressures leading to rising prices

The cost pressures facing Australian food retailing reflect a number of factors, including, importantly, the trend of a global surge in commodity prices for the key inputs to many food products, including grains and oils. This surge has been particularly acute over the past year.

The core factors contributing to this surge have been strong increases in demand due to government incentives to divert grain into biofuels (such as in the United States) and the strengthening economies in Asia and South America that have allowed a vast section of the world's population to spend more on food.

These new demand forces have occurred in a period of reduction in supply as crops have failed in some major producer countries due to weather conditions and because of the reduction of subsidy-induced artificially high stockpiles in the European Union and United States. 2008 is predicted to be the third year in a row in which fuel, food production and livestock feed needs consume more grain than is globally produced. Many countries are reporting food price increases as a result of cost pressures which have been described as "producing the biggest changes in global food markets in 30 years."<sup>1</sup>

Prices for Australian farm sector products are strongly integrated with global commodity price movements as it is estimated that around two-thirds of Australian farm output is exported each year.<sup>2</sup> In addition to global inflationary pressures, Australian producers have faced major weather-related shocks including long term drought, water restrictions and in other sectors severe cyclones, each of which have caused crop failures and supply shortages. As just one example, Australian wheat prices have more than doubled, increasing from \$200 per tonne in 2005 – 06 to \$450 per tonne in 2007 – 08.<sup>3</sup>

Therefore, food retailers in Australia in recent years have faced rising costs due to the effect of local weather-related shocks and rising world demand for commodities which, through export substitution, has reduced domestic supply and increased domestic supply costs. Unlike some sectors of retailing, such as electronic goods, where the rising Australian dollar and efficiencies in overseas supply markets have resulted in reduction of supply costs, the vast majority of fresh produce sold by Woolworths (over 97%) is domestically sourced due to specific import replacement and local purchase initiatives. Quarantine requirements also play a role in Woolworths' sourcing its fresh produce from Australian suppliers.

- (c) Woolworths price rises have been significantly lower than ABS Australian food price index *and* lower than the headline inflation rate

In these economic circumstances, in many cases suppliers' prices for food products supplied to Woolworths have increased, and when measured across all grocery items as supplied by Woolworths, retail prices have increased. However, the increase in price of the basket of food purchased by Woolworths customers over the period has been much less than that represented by the ABS Australian food price index and is less than, rather than significantly higher than, the Australian headline inflation rate. Woolworths asked CRA International to perform the price index analysis.

One reason that the ABS Australian food price index materially overstates the price increase for the basket that Woolworths customers actually buy is that the Australian food price index is a base weighted price index, not an expenditure index (as is the index constructed by CRA International). The trend for the Woolworths' customer basket changes as consumers alter their shopping patterns, for example in response to price increases and supply shortages that followed weather related shocks such as the Cyclone Larry banana price increase and supply shortage. However, the ABS Australian food price index is determined using a fixed basket of products and product weightings. The fixed basket and derived weightings are based on normal trading conditions (measured historically), which may therefore vary greatly compared to actual consumer baskets in periods of significant price change. In the current circumstances,

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<sup>1</sup> Wall Street Journal, September 28 2007, "Historic Surge in Grain Prices Roils Markets", S Kilman. This article appears at Attachment A.

<sup>2</sup> Department of Agriculture, Fisheries and Forestry (2005); Australian Agriculture and Food Sector Stocktake.

<sup>3</sup> ABARE, Australian Commodities, March 2008.

the ABS Australian food price index materially overstates the increase in cost Woolworths' consumers have actually experienced.

- (d) Woolworths' prices are low relative to international capital city prices for grocery staples

The significance and complexity of understanding the composition of the food basket, the index methodology, the base price, any weightings and base time periods, and overall concerns as to comparability, demonstrate the real problems in making any meaningful comparisons between food inflation rates in different countries.

It is instructive to note that the UK Competition Commission, in its latest investigation of the UK grocery industry, made an express decision *not* to focus on international price comparisons. In its interim report released in October 2007, the Competition Commission stated that:<sup>4</sup>

*... international comparisons of prices are difficult to make as a result of exchange rate issues, comparability of products and pack sizes, the role of tax in food prices, and different property markets and planning regimes. For these reasons, we consider that the value of any extensive cross-country comparison would be limited.*

However, notwithstanding these problems, and in view of the cornerstone significance of international price comparisons in the ACCC Issues Paper and the question as to whether there are other more relevant comparisons than the OECD food price inflation index comparisons, Woolworths has commissioned an international price comparison analysis for a range of staple groceries and household products for 35 international cities (including the 5 largest Australian capital cities).

The data was sourced from the Economist Intelligence Unit (EIU), which collects the data for the purpose of making cost of living comparisons. Woolworths matched the EIU products on the basis of its best selling lines for each product item, through which process a corresponding Woolworths price set for Sydney was identified. The data was converted into a common currency using purchasing power exchange rates obtained from the OECD.

In summary, the results of the analysis are that:

- the Sydney prices of Woolworths' best selling product lines are low relative to international capital city prices; and
- the Sydney prices on the basis of the EIU dataset (which surveys a number of retailers across a basket of goods) are close to the median when compared to other large international cities in Europe, North America and Asia.

The full report of this analysis can be found at Attachment B.

- (e) Australia's Take Home Food and Grocery Retailing Industry is diverse and very competitive

Woolworths competes for customer sales in take home food and grocery products (excluding liquor retailers and take away food outlets) against a range of retailers operating different retail formats. These retail formats include:

- supermarkets, such as Woolworths offering range, best value pricing, consistent quality, accessibility, convenience with supermarket level service;

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<sup>4</sup> UK Competition Commission (2007), *The Supply of Groceries in the UK market investigation, Provisional findings report*, October, page 27.

- specialist food retailers, offering depth of range, personal service, convenient locations in shopping centres and strips adjacent other food retail offers; and
- convenience stores, offering highest traffic food items in locations on major transport routes for consumers.

Customer surveys demonstrate that Australian bakery, meat, fruit and vegetable and deli customer sales are split between the different retail formats (supermarkets, specialist retailers and other food stores) and that customers cross-shop between the different retail formats.

Industry expert Tony Dimasi (of Pitney Bowes MapInfo) has prepared a report on the current composition of the Australian Take Home Food and Grocery Retailing Industry and changes in the composition over time. That report indicates that, on the basis of the ABS Retail Turnover Series for Food Sales, the share of total food sales captured by the ABS category defined as "Large Supermarkets" (comprising Woolworths, Coles, ALDI and Franklins, as well as the larger IGA and Foodworks banner supermarkets) has fallen over the period 1998 – 2007 from 66% to 63%. This report can be found at Attachment C.

Conversely, the ABS category "Other Supermarkets and Convenience Stores" (comprising smaller supermarkets and convenience stores) has over that period increased its share of total sales from 13% to 16%. All other food retailing (comprising primarily the various specialist stores) decreased in share in the beginning of the period but increased again to be 21% equal to the commencement of the period.

Net gains in store numbers across the different categories show that 48% of the increase in store numbers in the last 5 years has been by Fresh Food Specialities and 45% of the net gain by supermarkets and stores other than those of Woolworths and Coles. In this same period global retailer ALDI has also expanded rapidly representing 5% of the net gain in store numbers over the 5 year period, a very substantial increase given ALDI's small initial base of 48 stores, and the relatively large footprint of ALDI stores.

These results demonstrate that growth of Woolworths and Coles (major supermarket chains as termed in the Issues Paper) has not been at the expense of other retail formats, nor indeed of the independent sector.

(f) Woolworths' low costs / low prices model

Woolworths has operated under a low costs / low prices model for over 20 years based on consistently providing consumers with the best value basket of products, across the store and across a wide range of products. This philosophy is based on Woolworths' competitive everyday prices, price and value based promotions and specials, exclusive products and private labels, so as to provide consumers with confidence that for consistent quality, value and convenience they should choose to shop at Woolworths.

Woolworths sets its food and grocery prices competitively having regard to its national chain and independent competitors and to local store competitors including other supermarkets, grocery stores and specialist retailers.

Woolworths also competes on the basis of other factors that are important to its customers' shopping choices, such as high quality, range, accessibility, store layout and service. A focus restricted to price will fail to recognise other key influences not only for customers but also for Woolworths' supply relationships.

Woolworths has worked closely with its suppliers to support their investment in quality and new range, including through the difficult conditions in recent times. Proceeding on a basis that solely promotes "lowest price" would in certain areas tend to result in a higher proportion of imports (where allowed under quarantine requirements) rather than domestic supply. For example, Woolworths purchases as much Australian-sourced garlic as possible during the months that Australian garlic is available, even though it is of a higher cost than imported garlic.



## 1.4 Conclusions

Supply prices to retailers for food products in Australia have been rising due to a combination of global increases in demand and constrictions in supply, exacerbated by domestic factors such as drought, longer term water supply restrictions and weather shocks such as cyclones. Additionally, Woolworths is significantly affected by wider inflationary pressures bearing on the Australian economy, including rising fuel prices (and hence transport costs) and increases in property values (which increase imputed rentals).

Despite these factors, the trend of increase in retail prices based on actual consumer expenditure, as represented by Woolworths' customer expenditure, has been significantly lower than the trend represented by the ABS Australian Food Price Index and lower than the headline inflation rate. Woolworths' strong performance in improving productivity has been a crucial factor in allowing it to achieve these outcomes.

Similarly, meaningful international price comparisons do not indicate cause for concern that Australian food prices have exhibited abnormal increases or trends.

Indeed, other sectors of Australian industry, including health and education, have experienced much higher inflationary trends, as measured by their components in the Australian CPI, than the ABS Australian Food Price Index. However, this has not resulted in concern as to the competitiveness of pricing in those sectors.

Woolworths acknowledges Assistant Treasurer Chris Bowen's desire to "know if more can be done to ensure working families have access to a competitive market for basic food items".<sup>5</sup> Woolworths has sought to share with its customers the benefit of its cost of doing business reductions through moderation of cost inflationary pressures. The 8.1% increase in food and liquor sales in the Woolworths supermarkets in the first half of this financial year indicates that Woolworths continues to satisfy more of Australia's working families' needs.

These achievements are well-recognised by market analysts, as reflected by commentary on Woolworths' recent half-yearly results:<sup>6</sup>

*...five years of reformation and reinvestment has created a shining example of modernity in the Australian economy. Without super-efficient retailers like Woolworths, Australian consumers would be spending an awful lot more on their weekly shop.*

Woolworths welcomes policy initiatives such as those recently canvassed by the Treasurer to address Australian transport infrastructure bottlenecks and inefficiencies, which may produce logistics costs reductions for Australian food producers and retailers. Woolworths also supports initiatives to improve the ease for consumers in making meaningful product and price comparisons.

Woolworths will continue to contribute actively to this Inquiry.

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<sup>5</sup> *The Australian*, "Snap inquiry to probe supermarkets", S Maiden, 22 January 2008.

<sup>6</sup> *The Australian*, "Big result creates a riddle for Rudd", M Stevens, 27 February 2008.

## 2 Introduction to Woolworths Limited

### 2.1 Australian origins

Woolworths Limited was established in late 1924 by several Australian entrepreneurs. Woolworths today has over 2,000 stores across Australia, including 777 supermarkets. Within Australia, Woolworths' recognisable retail brands include Woolworths Supermarkets, Safeway, Big W, Dick Smith Electronics, Dick Smith PowerHouse, Tandy, Caltex/Woolworths, Caltex/Safeway, Woolworths Liquor, Safeway Liquor, BWS and Dan Murphy's.

Throughout its 84 years of operation, Woolworths' concept of retailing has essentially remained the same: serve your customers to the best of your ability and keep them coming back.

### 2.2 An Australian employer

Woolworths is the largest private sector employer in Australia, currently employing 155,532 people across all of its operations within Australia. Of these employees, 107,865 are currently employed within Woolworths Supermarkets. Woolworths' retail stores serve and employ Australians in metropolitan areas ranging from Hobart in Tasmania to Townsville in Northern Queensland, as well as in remote rural locations, for example Karratha and Derby in Western Australia.

### 2.3 A truly Australian investment

When Woolworths floated on the Australian Stock Exchange in September 1993, Australian shareholders, no matter how small their share parcels, were given priority over overseas investors and institutions. This decision resulted in over 330,000 new shareholders, comprising mainly small investors across the full range of socio-economic groups.

Today, a significant percentage of the company is owned by mum-and-dad type investors, with 58.9% (210,069 shareholders) holding less than 1,000 shares, and 36% (128,493 shareholders) holding between 1001 and 5000 shares. The commitment of Woolworths' own employees to the company is shown through the fact that 40,000 employees are also shareholders. Woolworths' performance means that it has assisted many Australians to improve their wealth.

### 2.4 Woolworths is committed to Australian suppliers

Woolworths recognises the importance of its relationships with Australian suppliers, and is proud that over 97% of Woolworths' fresh food (fruit, vegetables and meat) is grown and farmed in Australia. The mutually beneficial nature of Woolworths' relationship with its fresh food suppliers is shown through the fact that over 80% of Woolworths' 800 direct fresh food suppliers have been partners for more than a decade. 90% of Woolworths' Homebrand range is sourced in Australia, providing further evidence of Woolworths' support of Australian suppliers.

### 2.5 Woolworths is committed to its customers

Woolworths Supermarkets is the leader in fresh food quality, range and value. It is well-known for its commitment to convenience, quality, value and service, a commitment that is reinforced through its customer-focused vision and mission statements. Without this dedication to its customers, Woolworths would not be able to deliver excellent service to its customers or provide growth for its shareholders.

Woolworths has grown in response to its customers needs and preferences. It opens new supermarkets in areas of population growth and new customer demand. Its preference is to open on a greenfields site allowing it to plan its optimal store layout and offering.

## 2.6 Woolworths is committed to the future

In addition to its commitment to its customers, Woolworths is committed to the future of Australia. Through being the largest trainer of apprentices in Australia, currently training around 5,000 apprentices, Woolworths is investing in the future growth of the nation. Woolworths is also committed to assisting its fresh produce suppliers to develop better quality products, in turn benefiting the end customer. Finally, Woolworths has helped to contribute around \$15 million annually to Australian & New Zealand charities. For over a decade, Woolworths has been the single largest corporate supporter of Australian children's hospitals.

### 3 Inflationary pressures on input costs

Over the past 2 years Australian food producers and retailers have faced strong inflationary pressures in underlying costs such as fuel, grain (as an input and livestock feed), transport and packaging. These pressures have moved with global trends and have been exacerbated by local factors such as extensive drought and cyclones.

These cost pressures are giving rise to retail price inflation in many countries.

#### 3.1 Supplier feedback as to cost pressures

Over the past year suppliers have notified Woolworths of the necessity to implement price increases in their products due to unprecedented cost increases that they were facing and their need to continue to support Australian farmers and products.

In summary, the cost increases referred to by suppliers and their causes have included a mix of global and domestic factors as follows:

Factor	Results
Drought	<ul style="list-style-type: none"> <li>• failure in grain crops in last 2 successive years along the Australian east coast</li> <li>• grain shortages</li> <li>• massive increases in grain commodity prices</li> <li>• spike in animal feed costs</li> <li>• reduction in overall Australian farm production (not just grain, also other products such as dairy which are dependent upon feed or other crops dependent on water supply such as fruit and vegetables) as farmers leave industry due to drought and debt</li> <li>• flow on effects to any food sector that utilises feed, grains, flour, crumbs, starches</li> </ul>
Water supply constraints	<ul style="list-style-type: none"> <li>• reductions in allocations to farmers</li> <li>• increases in water right/diversion licence charges and in actual and implied water prices, increasing cost of produce</li> </ul>
Record oil prices	<ul style="list-style-type: none"> <li>• increases across the board such as in freight and packaging materials</li> </ul>

These, and other factors, have given rise to the following outcomes:

Outcome	Reasons
Worldwide shortage of grain stocks, resulting in large increases in global grain commodity prices (which flows onto Australian pricing due to export substitution effects)	<ul style="list-style-type: none"> <li>• strongly increasing demand in Asian and South American economies</li> <li>• diversion of grain into bio-fuel production in response to subsidies and higher fuel prices</li> <li>• depletion of previous stock piles as some farm subsidies in developed countries have been reduced</li> </ul>
Worldwide shortage of dairy fats, resulting in unprecedented uplift in global dairy commodity prices	<ul style="list-style-type: none"> <li>• strongly increasing global demand for dairy products (increasing at 3% per year and averaging 5% increase in developing countries)</li> </ul>

Outcome	Reasons
(which flows onto Australian pricing due to export substitution effects)	<ul style="list-style-type: none"> <li>• net decline in world exports</li> <li>• reduction of EU subsidies on Skim Milk Powder (SMP) and Whole Milk Powder (WMP) and soon to be reduced subsidies on cheese and butter</li> </ul>
Increased regulatory compliance costs	<p>Examples given include:</p> <ul style="list-style-type: none"> <li>• water trading rights regimes; and</li> <li>• new 2008 Animal Welfare Legislation compliance</li> </ul>

### 3.2 Commodity price spikes

There has been a significant lift in world price for wheat, coarse or feed grains, oilseeds and dairy products over the last few years. These have been the result of both adverse weather conditions in Australia and overseas as well a number of recent agricultural policy changes in the US, EU and other countries. These world prices increases have offset the effect of a higher Australian dollar and domestic prices have also risen sharply. Strong demand in Asia has also supported agricultural commodity prices, particularly in Australia.

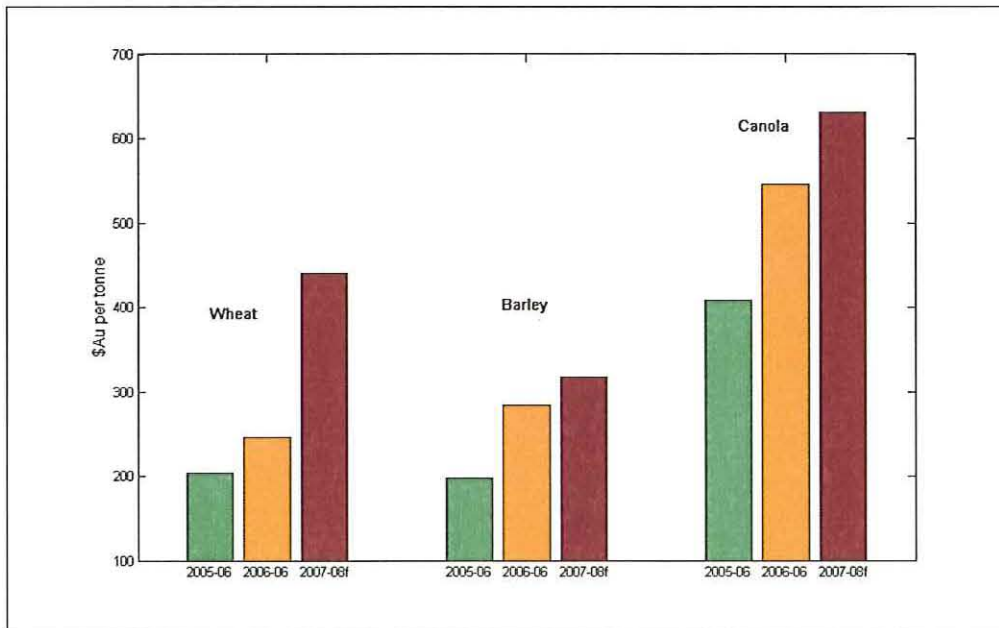
Some of the key features of these increases are outlined below. The information has been sourced from ABARE's March 2008 issue of *Australian Commodities*.

Wheat prices in 2007-08 have reached record highs in both real and nominal terms. Low opening stocks and poor harvests in a number of important growing regions including Australia have been a major factor in this price rise. In an attempt to reduce upward pressure on domestic prices, Argentina, the EU and the Russian Federation all introduced new policies that have put additional upward pressure on wheat prices. Argentina increased wheat export taxes, the EU reduced import duties and Russia imposed direct restrictions on trade. While high price should lead to greater plantings and bigger harvests in the coming year, this will be dampened by high fertiliser costs.

Coarse grain prices have also been high over the past two years. A significant factor has been the diversion of corn and land into the production of corn for ethanol in the US. The US government provides a subsidy of about 13 cents per litre on ethanol. These policies are not likely to change in the coming year. Poor weather conditions also affected feed grain supplies in 2007-08. This will have flow on effects to intensive livestock industries including grain-fed beef, pigs and poultry.

The factors referred to above have produced commodity price spikes globally and domestically, as illustrated in the following charts:

**Figure 1: Australian wheat, feed grain and oilseed prices (2005-06 to 2007-08)**



Source: ABARE, Australian Commodities, March 2008

**Figure 2: A significant global price spike in wheat has occurred**



Source: Mintec Commodity Price Information Services

Oilseed prices also reached record highs in 2007-08. Strong demand for biodiesel fuels in the EU, coupled with US subsidies of around 26 cents per litre for biodiesel, have diverted substantial amounts of production and have placed upward pressure on prices. Biodiesel in Asia is starting to grow with policies directed at increasing demands on supply in China, Malaysia, Korea and Singapore.

The related price spike is illustrated in Figure 1 above, and also in Figure 3 below:

**Figure 3: A significant price spike in vegetable oil has occurred**

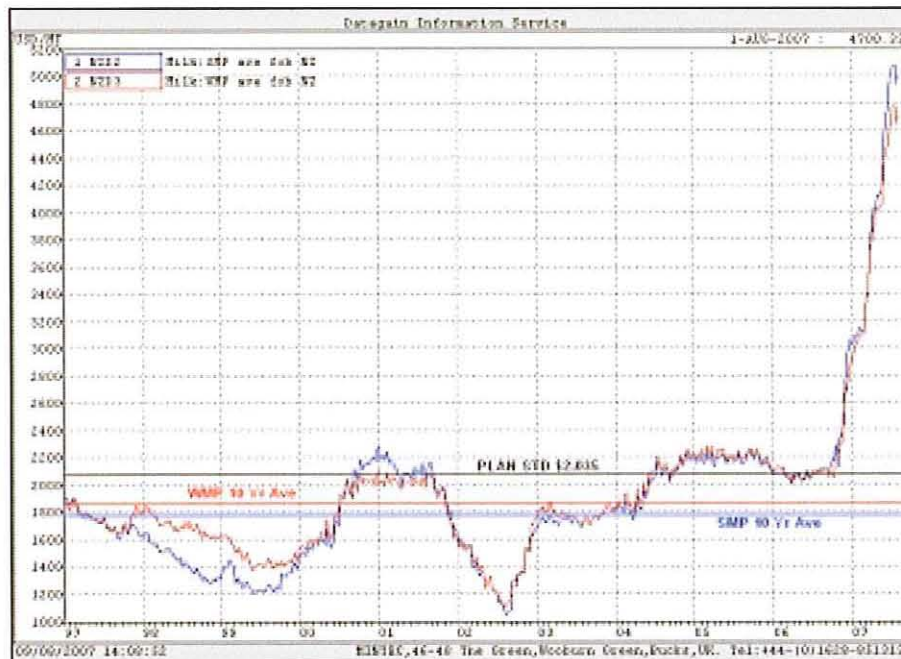


Source: Mintec Commodity Price Information Services

In addition, dairy prices rose sharply in 2007-08, in part due to poor weather in key exporting countries, most notably Australia. The EU reduced a dairy subsidy which has also led to reduced production. However, production is expected to increase in the coming year, especially in New Zealand.

The price spike in milk pricing is illustrated in Figure 4 below:

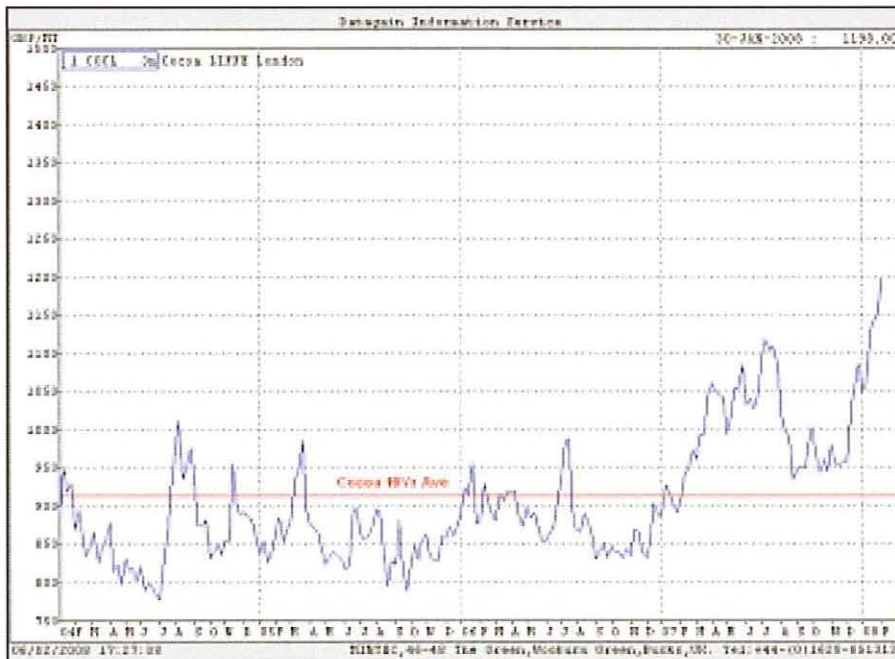
**Figure 4: A significant price spike in milk pricing (powders and AMF) has occurred**



Source: Mintec Commodity Price Information Services

There has also been a significant price spike in cocoa, as illustrated in Figure 5 below:

**Figure 5: A significant price spike in cocoa has occurred**



Source: *Mintec Commodity Price Information Services*

Of even greater concern is commentary that these increases are likely to last over the longer term due to the longer term nature of the increases in demand and doubts as to any ability to substantially increase land under cultivation or crop yields.<sup>7</sup>

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<sup>7</sup> *Wall Street Journal*, "Historic Surge in Grain Prices Roils Markets", September 28 2007, S Kilman. This article appears at Attachment A of this Preliminary Submission.



## 4 Retail Price Inflation

### 4.1 Australian Food Price Index

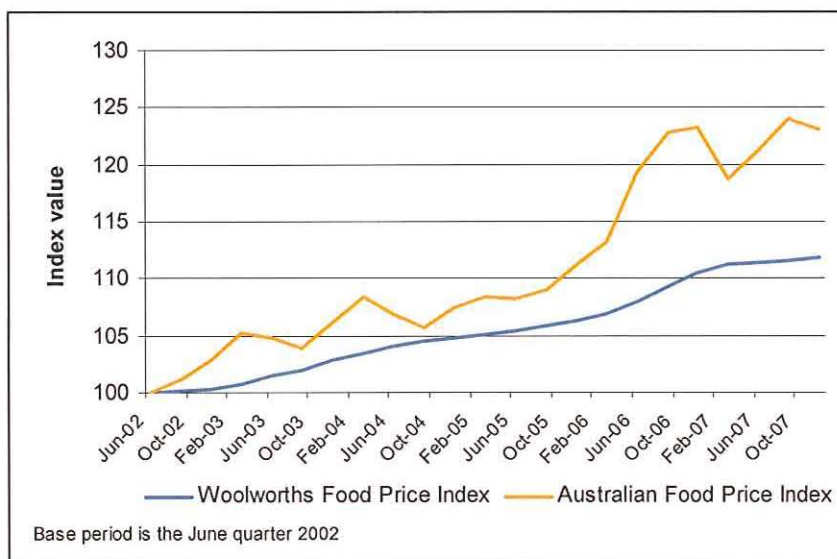
The ACCC's Issues Paper has, as a cornerstone context setting issue, the statement that grocery food prices have increased at a significantly higher rate than the headline inflation rate. It is correct to say that the Australian food price index has increased at a significantly higher rate than the headline inflation rate. However, Woolworths' knowledge of its own price increases meant that it was aware that its prices had not risen in such a volatile manner nor at such a rate. For this reason Woolworths asked CRA International to test whether a basket of Woolworths' actual grocery price increases had increased at such a significantly higher rate as suggested in the ACCC's Issues Paper.

Woolworths asked CRA International to construct a "Woolworths food price index" to test the extent of inflation of Woolworths prices compared with the index reported by the ABS for Australia generally.<sup>8</sup>

The results below demonstrate that the Australian food price index greatly overstates the price increases experienced by Woolworths' customers for the basket of food that they buy. This is borne out by two measures.

First, the Woolworths food price index is rising at a significantly lower rate than the Australian food price index, and is much less volatile, as Figure 6 shows.

**Figure 6: Woolworths' food price index compared with the Australian food price index**

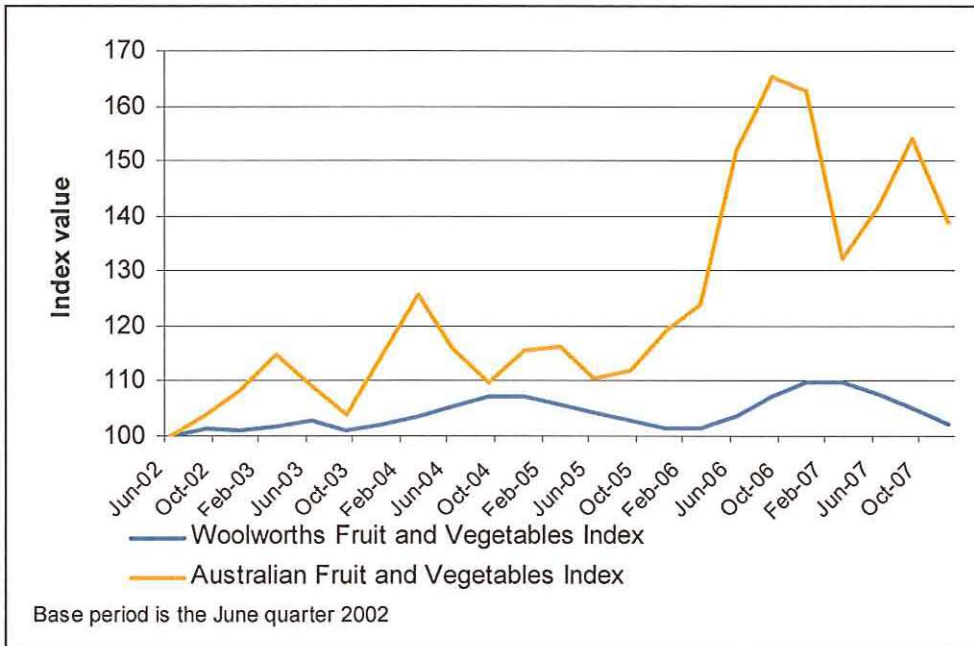


<sup>8</sup> CRA constructed a Woolworths food price index based on quarterly sell price increases provided to the Reserve Bank of Australia over the last five years for given product categories. These categories were matched with ABS weights for the Australian food price index (as included in the Headline CPI calculations). Woolworths food price indices are calculated on a revenue weighted basis as opposed to the ABS Australia CPI which is calculated on a fixed weight basis for 5 years. For the majority of food categories, ABS categories were matched as closely as possible with Woolworths' categories and these were summed to create the Woolworths weight. (That is, fixed weights were applied to the Woolworths categories to align the Woolworths food price index with the Australian food price index.) In the case of bread, there was one ABS and two Woolworths categories. In this case, one half of the ABS weight was assigned to each Woolworths category. The Woolworths general merchandise and service delicatessen categories were excluded. The Australian food price index includes meals and take-away foods. These were excluded from the index and the index was then rebased. The Australian food price index does not include tobacco products or liquor and so these were also excluded from the Woolworths food price index.

The index constructed by CRA International is expenditure weighted, rather than using base period quantity weights (as is the case in the ABS CPI). As a result, it is technically an expenditure index, rather than a price index.

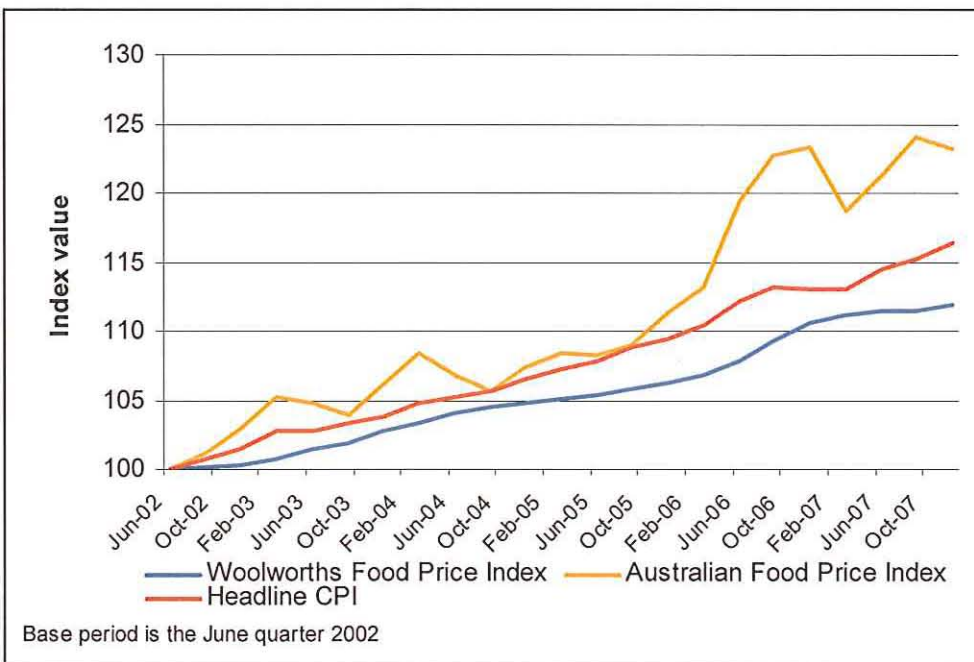
Second, in the fruit and vegetable category, where availability and prices can be particularly volatile, Woolworths performs even better. Here, the divergence is even larger in favour of a lower rate of increase in Woolworths' prices, as shown in Figure 7.

**Figure 7: Fruit and vegetables index comparisons**



Moreover, the Woolworths food price index is lower than the *headline* CPI rate reported by the ABS, as shown in Figure 8.

**Figure 8: The Woolworths Food Price Index versus the Australian Food Price Index versus Headline CPI**

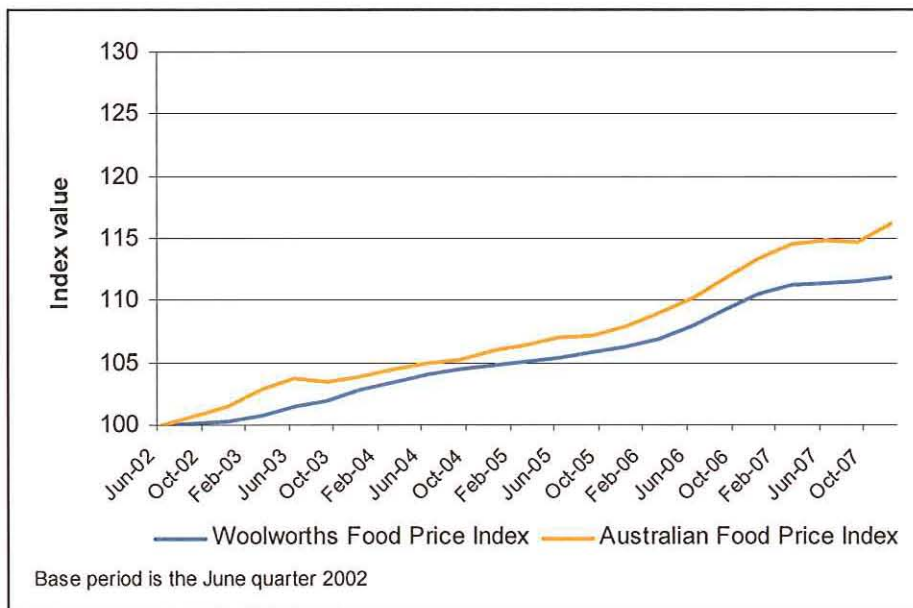


Noting that there is a large difference in the calculated Woolworths fruit and vegetable index and the Australian fruit and vegetables index, a test was constructed to examine the impact that this difference may have on both the Australian and Woolworths calculated food price indices:

- First, the Australian food price index was recalculated using Woolworths' component price changes for fruit and vegetables.
- Second, Woolworths' food price index was recalculated using the ABS component price changes for fruit and vegetables.

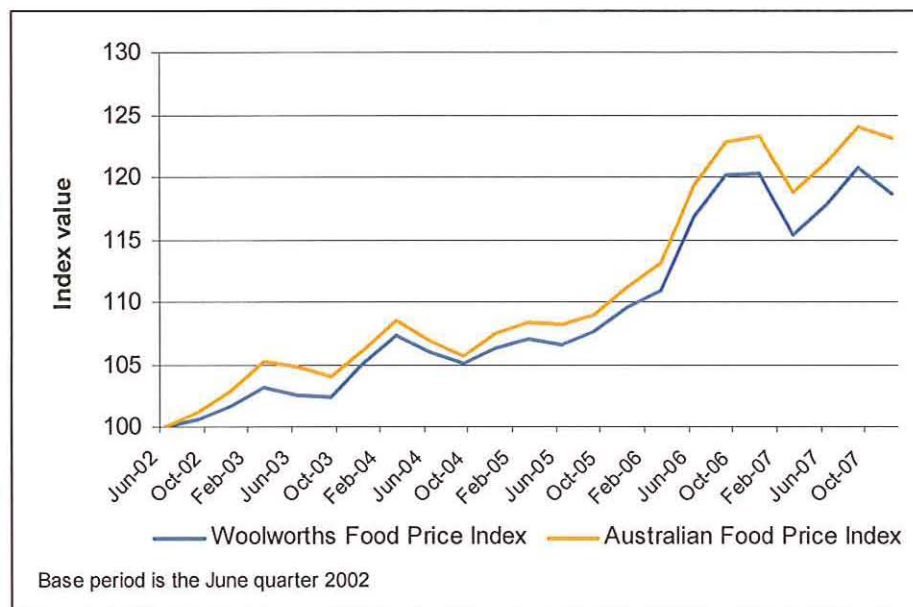
The results of this test can be found at Attachment D of this Preliminary Submission (in CRA International's full report on Food Price Indices).

**Figure 9: Food index comparison (using Woolworths' fruit and vegetable price data in both indices)**



*Note: Australian CPI fruit and vegetable data have been replaced with Woolworths' fruit and vegetable data*

**Figure 10: Food index comparison (using Australian fruit and vegetable price increases in both indices)**



*Note: Australian CPI fruit and vegetable data have been replaced with Woolworths' fruit and vegetable data*

The test confirms that:

- the Woolworths food price index and the Australian food price index, while constructed using different pricing components, are reasonably consistent and meaningful comparisons can be made; and
- the increase in the Australian food price index since June 2006 is largely due to the increase in fruit and vegetable prices as measured by the ABS.

#### 4.2 The Australian food price index does not measure the prices *actually* paid by consumers

It is important to note that the Australian food price index uses weights that are fixed over a 5 year period and the components in the Woolworths food price index uses current revenue weights. As a consequence the Australian index will be more sensitive to price changes and periods of limited supply as it does not account for the fact that consumers can and do change the composition of their basket.

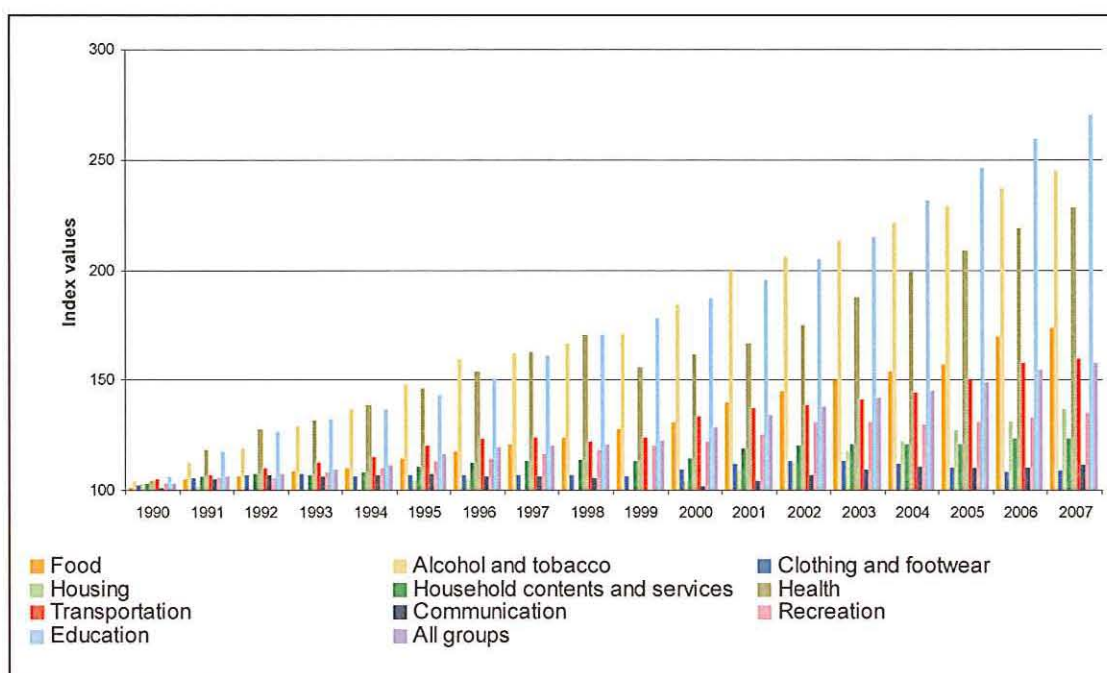
The Woolworths food price index is based on actual selling volumes, and is an expenditure index. If a product's price spikes, the data and index will reflect that (ie high prices multiplied by small volumes), giving a truer picture of the impact of those prices upon the outlays made by Woolworths' customers.

For example, the ABS index assumes consumers continued weighting their basket with the same volume of bananas, notwithstanding the prevailing high nominal selling prices following Cyclone Larry when there was almost complete unavailability of the single largest selling product in a supermarket (bananas) for an extended period. Given that the volume of bananas sold during that period shrank considerably as consumers replaced most or all of the bananas in their shopping basket, the ABS index does not give a true reflection of the impact of prices upon the cost of consumers' outlays. For example, to the extent to which consumers regard other fruits as a good substitute for bananas, consumer welfare will have been far less adversely affected by the increase in banana prices than the ABS index would suggest.

#### 4.3 Australian food price index compared to various other components of CPI

Although the focus of this inquiry is on groceries, it is obviously important to acknowledge that price pressures are also being felt elsewhere in the economy. Figure 11 shows that growth in food prices as measured by the ABS is well below that experienced in some other sectors of the Australian economy over the longer term, including health and education where the respective components of the CPI have risen at a significantly higher rate.

**Figure 11: CPI – various components (annual %)**



Source: ABS Data; CRA International analysis

#### 4.4 International comparisons are unreliable

Much has been made in the context of this inquiry of food price inflation in Australia relative to that in other advanced economies. However, such comparisons are at best limited in value by both conceptual and measurement problems, and at worst positively misleading.

At the threshold, there are virtually insurmountable problems in internationally calibrating the non-price dimensions of the products whose price is being measured. Is the cheese, milk or flour of the same quality? Are the carrots equally fresh? These issues also exist with domestic comparisons, but are all the more acute for international comparisons where supply chain practices are likely to differ more widely.

The underlying cost of doing business will also vary more widely across countries than within them. For example, there are important differences in population and physical geography (e.g. lower population density) that impact transport and fuel costs.

International comparisons are also highly exposed to methodological issues in how the surveys are conducted. For example, they are highly susceptible to price level variations at the commencement of the period under study, since it is easier to make percentage gains off a low base than a high one. They are also vulnerable to the selection of the period for comparison – a country that makes gains prior to the study period will be “punished” if other countries then make up ground during the study period.

Exchange rate assumptions, variations in exposure to global food markets and the impact of trade protection also make such comparisons hazardous. For example, trade protection in some countries have muted Australian exports and constrained domestic prices. As foreign markets opened up (however slowly and unevenly), exports rose and supply to domestic markets was reduced, while at the same time reducing food prices in the export country. In other words, to the extent to which world food markets have effectively become more integrated, previously lower Australian food prices will rise (reflecting Australia's comparative advantage in food production) while previously higher prices in foreign markets fall. Though greater openness in international trade is doubtless to be welcome, its working out in food prices will generate

unfavourable comparisons in Australia's food inflation rate for reasons that have nothing to do with supermarkets.

Other quite unrelated factors can impact food prices. In the case of wheat, alternative non-food uses (i.e. biofuels) are emerging to drive up demand and raise prices of wheat-based food products. Where increases in demand are overlapped by rising costs of supply, as occurred due to the drought, the impact on domestic prices is even more severe. Again, these factors can cause Australia to be unfavourably compared with other countries, but have nothing to do with supermarkets.

We elaborate in further detail on the problems with international inflation comparisons at Attachment E.

It is instructive to note that the UK Competition Commission, in its latest investigation of the UK grocery sector, made an express decision *not* to focus on international price comparisons. In its interim report released in October 2007, the Competition Commission stated that:<sup>9</sup>

*... international comparisons of prices are difficult to make as a result of exchange rate issues, comparability of products and pack sizes, the role of tax in food prices, and different property markets and planning regimes. For these reasons, we consider that the value of any extensive cross-country comparison would be limited.*

That this conclusion was reached notwithstanding more than two decades of progress towards a single European market and common regulatory arrangements merely highlights the difficulties involved in making international price comparisons. Many of the same concerns (as well as others noted in Attachment E) apply when comparing price changes internationally over time.

In view of the cornerstone significance of international price comparisons in the ACCC Issues Paper and the question as to whether there are other more relevant comparisons than the OECD food price inflation index comparisons, Woolworths has commissioned an international price comparison analysis for a range of staple groceries and household products for 35 international cities, including the 5 largest Australian capital cities. The full report of this analysis is attached at Attachment B.

The data was sourced from the Economist Intelligence Unit (**EIU**), which collects the data for the purpose of making cost of living comparisons. Woolworths matched the EIU products on the basis of its best selling lines for each product item, thereby identifying a corresponding Sydney price set for Woolworths for its Homebrand and name brand product ranges. The data was converted into common currency using purchasing power exchange rates obtained from the OECD.

In summary the results of the analysis are that:

- Woolworths' home brand basket prices are low relative to international capital city prices, including Sydney;
- Woolworths' name brand basket prices are also low relative to international capital city prices. In general, the price range of Woolworths' name brand is below the corresponding prices for Sydney city, however, the median is higher for the Woolworths' name brand prices due to the wider spread of prices between the

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<sup>9</sup> UK Competition Commission (2007), *The Supply of Groceries in the UK Market Investigation, Provisional Findings Report*, October, page 27.

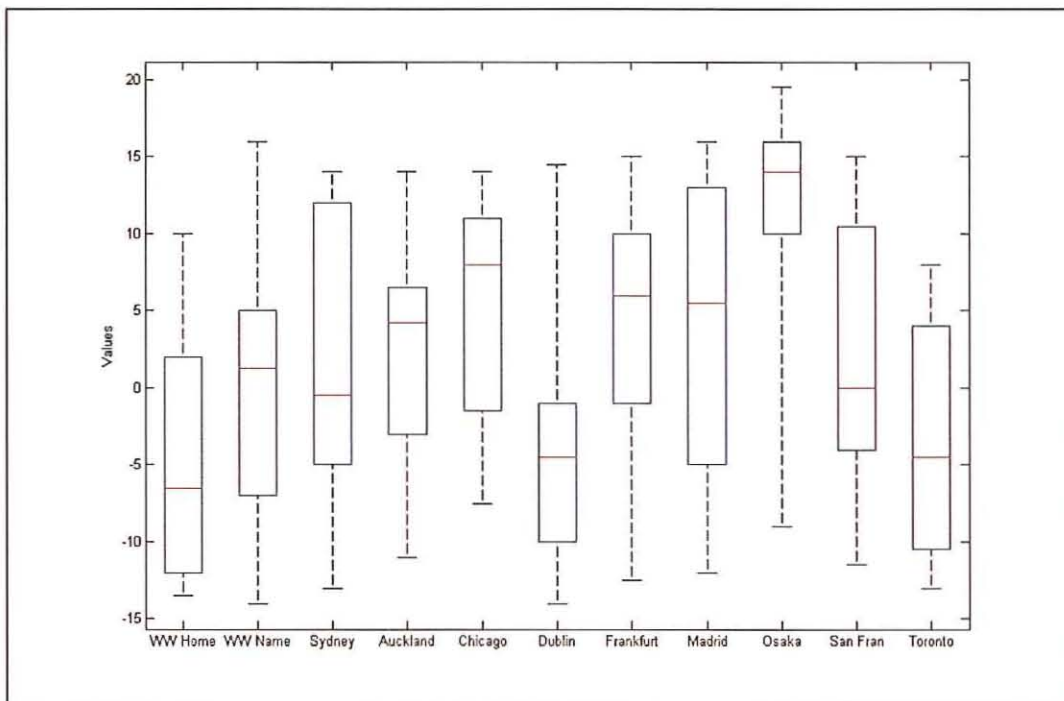
median and the 25th percentile. In other words, the range of prices below the median is greater than the range of prices above the median; and

- Sydney's prices, across a basket of goods, are close to the median when compared to other large international cities in Europe, North America and Asia.

The box and whisker plots of the ranks for selected cities (compared against the Woolworths Homebrand and Woolworths name brand prices) are shown in Figure 12 below. The range of the plots indicates the range of the ranks for the various products in a given city. The box corresponds to the 25th to 75th percentiles of the ranks. The median rank, indicated by the red line in the box, corresponds to the median rank for that city.

From an interpretive point of view, the boxes should be seen as the central range of prices within the basket of goods for the different cities. The median should be seen as the overall basket price. As the box contains 50 per cent of the observations, it provides a more reliable picture of the cost of a basket than the median.

**Figure 12: The distribution of product price ranks in PPP terms for Woolworths in Sydney and selected capital cities**



Source: CRA International analysis, based on data from the Economist Intelligence Unit and Woolworths

## 5 The current food retailing environment is diverse and very competitive

### 5.1 Introduction

Woolworths operates in a highly competitive take home food and grocery retail sector, which ensures that Australian consumers benefit from a wide choice of good quality, safe, fresh food and other groceries at prices that are relatively low by world standards. In addition to competing with other chains of larger and smaller supermarkets, Woolworths competes with specialty stores and convenience stores for consumer sales of take home food and groceries. This is because the retail "offer" does not merely include the product range, but includes elements such as store presentation, access and parking; product range and choice; product quality and safety; service levels; product prices and convenience. In other words, suppliers compete not merely over price, but also over the many non-price dimensions of output, expanding the range of choices available to consumers, who in turn "pick and choose" among those options.

The increasing time demands on working families have meant that food retailers have expanded ranges of ready to eat/ready to prepare meals bringing them into closer competition with take-away food outlets. While those outlets have not been included in the figures presented below, they are part of the relevant competitive landscape.

The highly competitive and evolving sector has resulted in the development of structures, such as national banner groups, vertically integrated supply and distribution arrangements and extended product ranges, which maximise the competitiveness of the different retail businesses.

Woolworths asked industry expert Tony Dimasi, of Pitney Bowes MapInfo, to prepare a report as to the current composition of the Australian food retailing environment and its change in composition over time. That report is attached at Attachment C.

### 5.2 Trends in grocery retailing

Competition for the retail sale of grocery products occurs across a spectrum of formats, including supermarket, convenience and specialty stores and more generally across a spectrum of relevant competitive factors, including price, quality, service, range and convenience. While these formats have different characteristics, they are ultimately seeking to meet the same consumer demand, and to increase their sales and share of sales in the face of competition.

On the basis of ABS Food Retail Division reports, the number of stores in 2006/07 split in the following percentages between the different categories of stores: 28% supermarkets and smaller grocery or convenience stores and 72% specialist food retailers. This is broken down further in the table and chart below.



**Table 1: Food Retail Division, number of establishments (2003-2007)**

**Food Retail Division, Number of Establishments: 2003-2007**

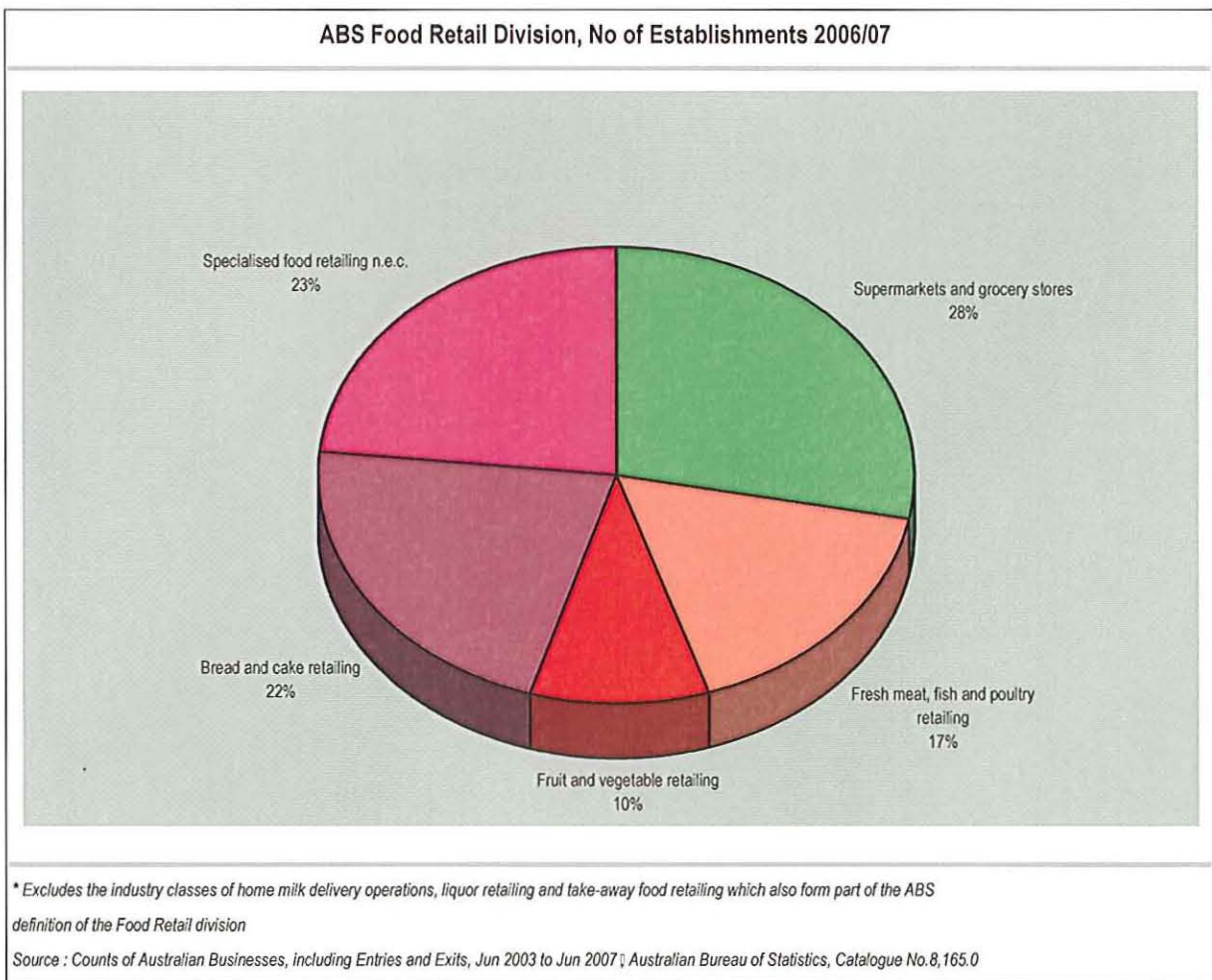
Industry Class	No. of Businesses					Net Gain/ Loss, 03-07
	2002/03	2003/04	2004/05	2005/06	2006/07	
Supermarkets and grocery stores	7,506	7,890	8,250	8,223	8,535	1,029
Fresh meat, fish and poultry retailing	4,968	4,980	4,950	4,959	5,142	174
Fruit and vegetable retailing	2,742	2,766	2,829	2,835	2,928	186
Bread and cake retailing	6,357	6,798	6,678	6,606	6,702	345
Specialised food retailing n.e.c.	<u>6,840</u>	<u>7,179</u>	<u>7,449</u>	<u>7,572</u>	<u>7,113</u>	<u>273</u>
<b>Total Food Retail Establishments*</b>	<b>28,413</b>	<b>29,613</b>	<b>30,156</b>	<b>30,195</b>	<b>30,420</b>	<b>2,007</b>

\* Excludes the industry classes of home milk delivery operations, liquor retailing and take-away food retailing which also form part of the ABS definition of the Food Retail division

Source : Counts of Australian Businesses, including Entries and Exits, Jun 2003 to Jun 2007 ; Australian Bureau of Statistics, Catalogue No.8,165.0

Note: This table presents the total number of businesses that are engaged in take-home food retailing (as defined in \* above)

**Figure 13: ABS Food Retail Division, number of establishments (2006/07)**



(a) The "top up" trend

One significant trend in grocery retailing has been customers making more frequent, lower-value purchases in each visit to meet their short term needs for food and groceries (**top up trend**). This has resulted in a shift away from a shopping mode in which customers make infrequent visits to a single retailer for a high value purchase of a "basket" of products. For example, based on Woolworths data as at February 2008, Woolworths' national average customer transaction purchase value is \$36.34 with an average basket size of 10.01 products, and 21.6% of customer transactions (by value) are below \$30.

As a result of this trend, larger scale supermarkets compete ever more closely with small supermarkets, convenience and specialty stores for the same retail sales, with each format adopting competitive strategies to capture these customers.

Larger supermarket retailers have responded by moving to a more convenience based retail experience format by larger supermarket retailers through:

- improving access to stores (through expanding the range of locations);
- improving access within stores (through express lanes and product layout); and
- targeting other elements of competition such as product range, service and price.

A result of these changes has been an increase in convenience style purchases through supermarkets. For example, 54% of Woolworths' customers use the "express" checkouts (provided for the use of shoppers with smaller baskets of goods), whereas 38% use the regular checkouts and the remaining 8% use the front kiosk.

In order to effectively compete with supermarkets, specialty and convenience stores have, in turn, tried to emulate the larger product range available at supermarkets (for example, confectionery, soft drinks, cigarettes, milk and bread).

(b) The "cross shopping" trend

Because of the comparable offerings available within specialty stores, supermarkets and convenience stores, shoppers are now able to avail themselves of a wide range of retailers to provide their grocery requirements. Accordingly, consumers often "cross shop", that is, they do not shop exclusively at supermarkets or specialty stores.

The vigorous competition between specialty stores and supermarkets is evidenced through the reality that:

- consumers regularly compare the meat, seafood, delicatessen, bakery and fruit and vegetable departments in supermarkets with comparable offers of specialty retailers;
- Woolworths' fresh produce departments closely monitor developments in the range and pricing of product ranges offered by specialty stores; and
- specialty stores monitor the fresh produce on offer at supermarkets such as Woolworths.

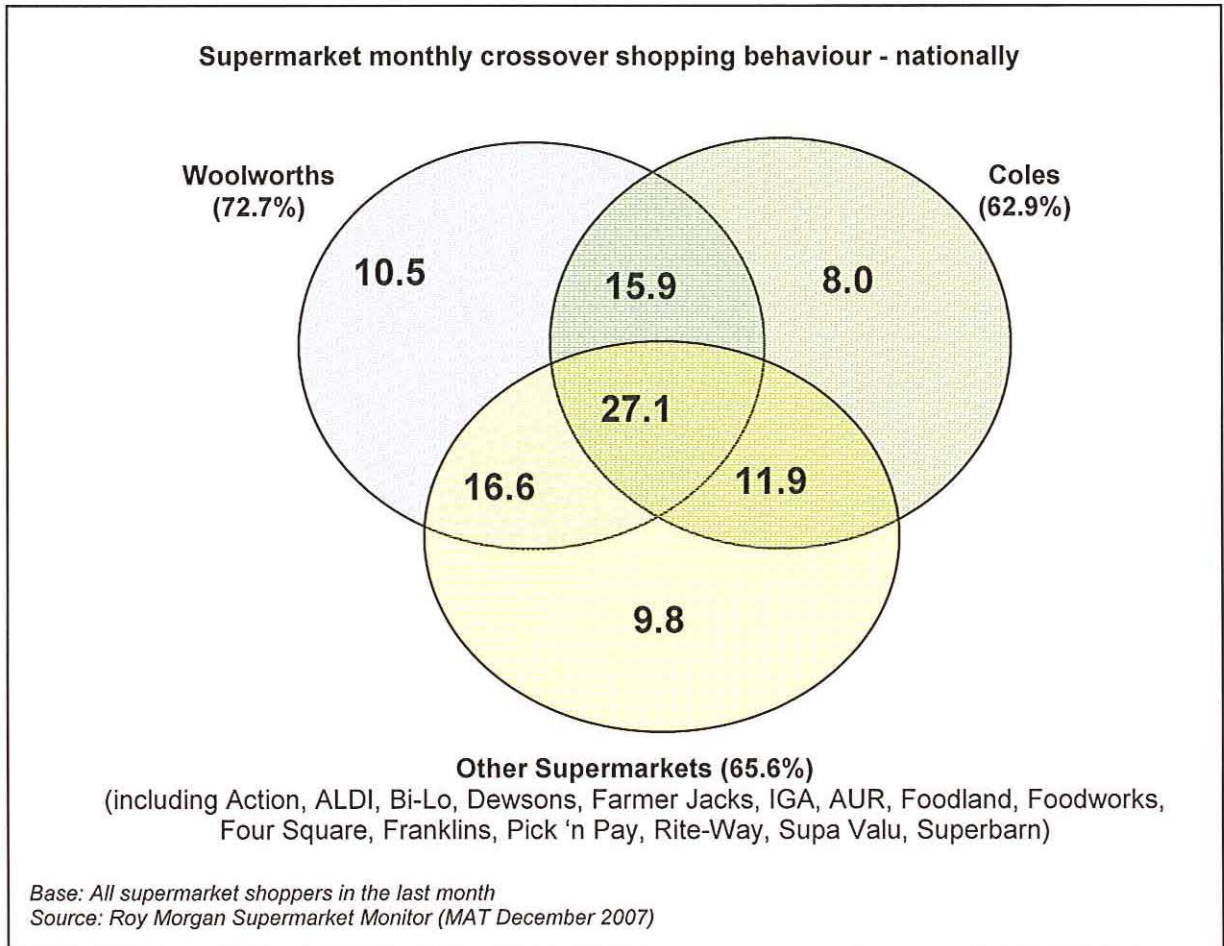
Such close monitoring by all parties is necessary since specialty stores and supermarkets are typically positioned near one another in shopping centres and shopping precincts.

Roy Morgan market research indicates that customers engage in cross-shopping across different supermarket operators and the differing store formats such as specialists. This is illustrative of the competitive nature of the grocery retailing environment in which Woolworths competes.

For example, the Venn diagram below (prepared by Roy Morgan on the basis of the Roy Morgan Supermarket Monitor as at December 2007, surveying the supermarkets that

participants shopped in over the last month) shows that only 10.5% of shoppers surveyed shopped exclusively at Woolworths, while 27.1% of shoppers shopped at Woolworths, Coles and other supermarkets. This suggests a lack of customer loyalty among supermarket customers, and hence the imperative that supermarket operators continue to deliver on all elements that customers consider important when making a purchase, including not just price, but also quality, range and service.

**Figure 14: Cross-shopping occurs across different supermarket chains**



Furthermore, in each of the "fresh" produce areas (bakery, meat, fruit and vegetables, and the delicatessen) the Venn diagrams below illustrate that Woolworths faces strong competition from specialist retailers as well as from other supermarket operators.

Figure 15: Cross-shopping occurs across retail formats for bakery items

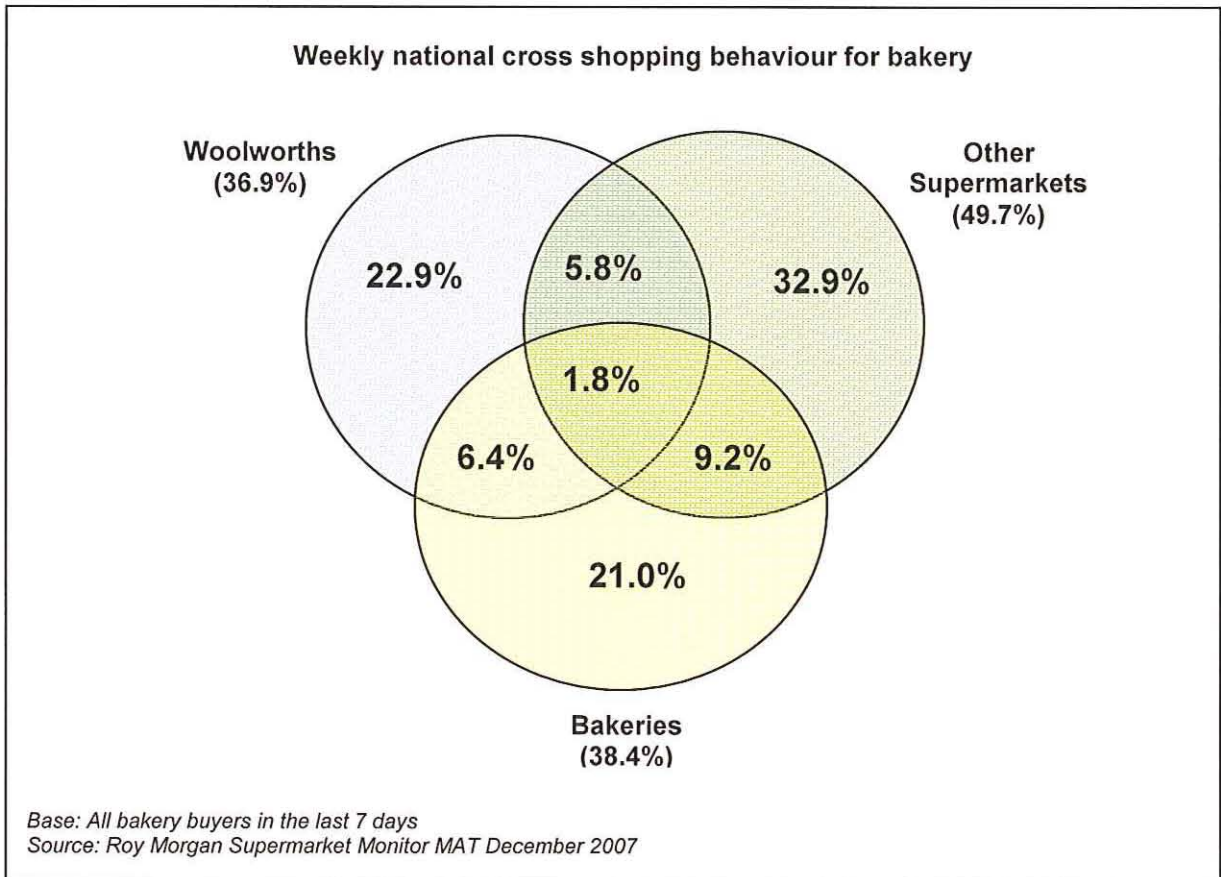


Figure 16: Cross-shopping occurs across retail formats for meat

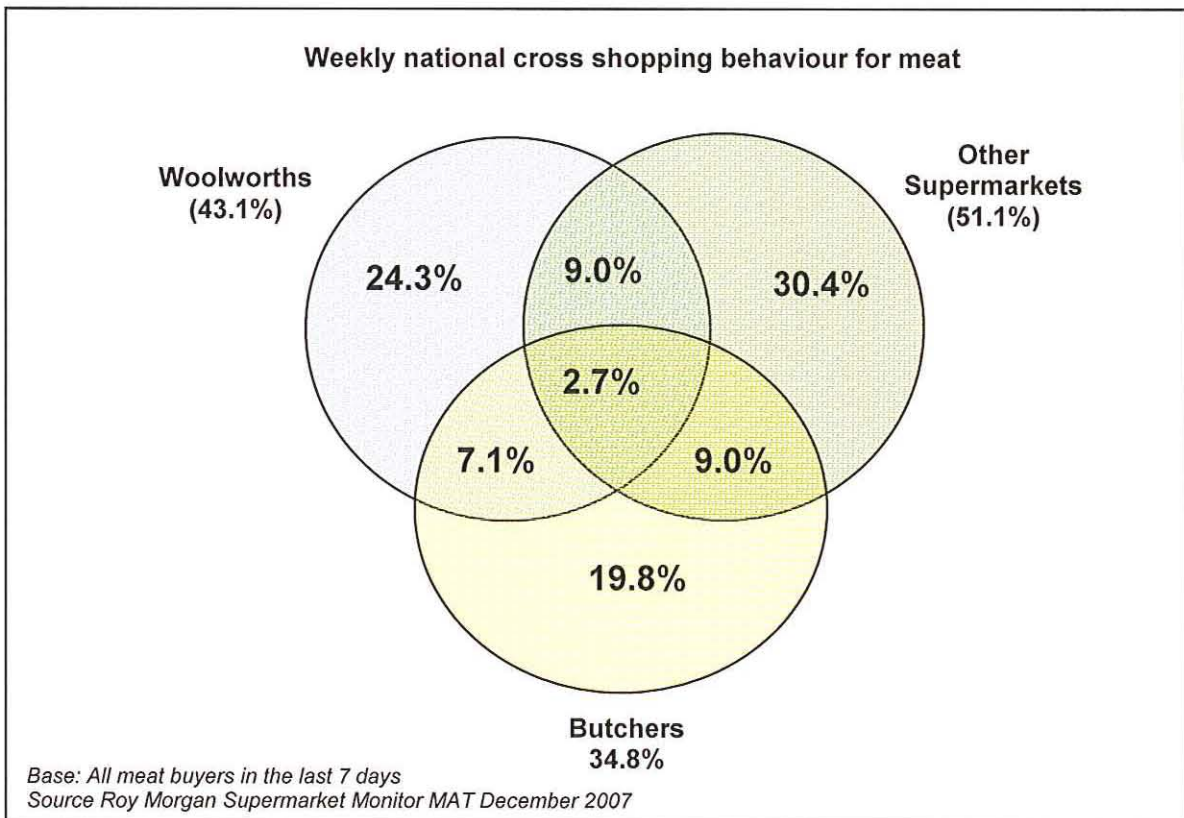


Figure 17: Cross-shopping occurs across retail formats for fruit and vegetables

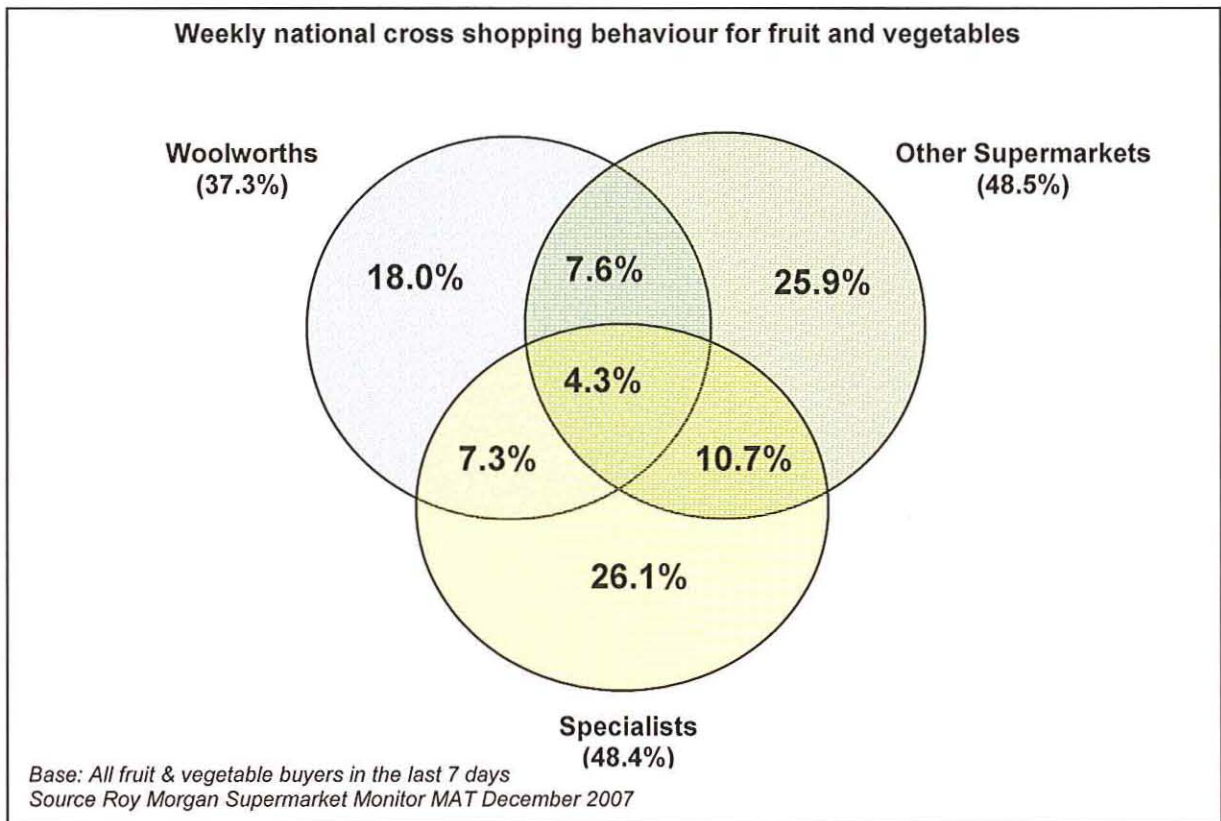
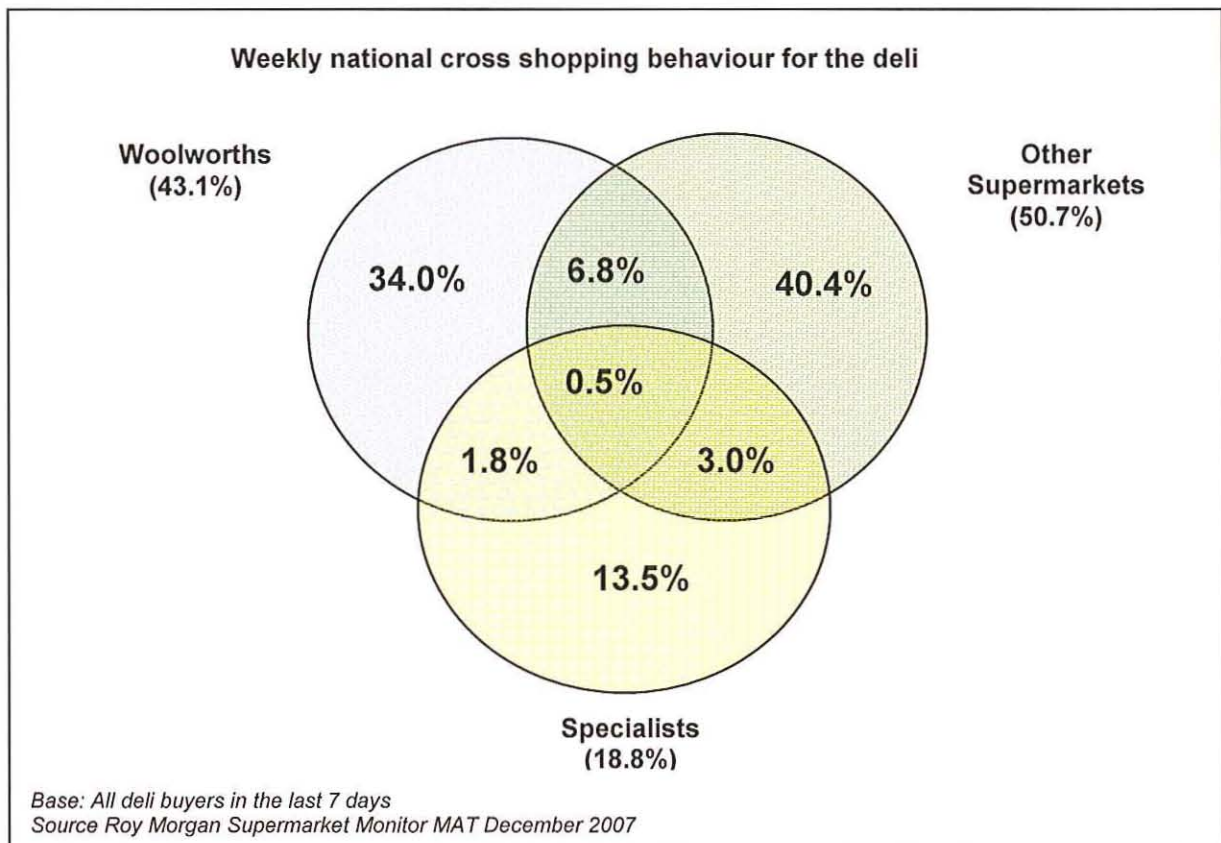


Figure 18: Cross-shopping occurs across retail formats for deli items

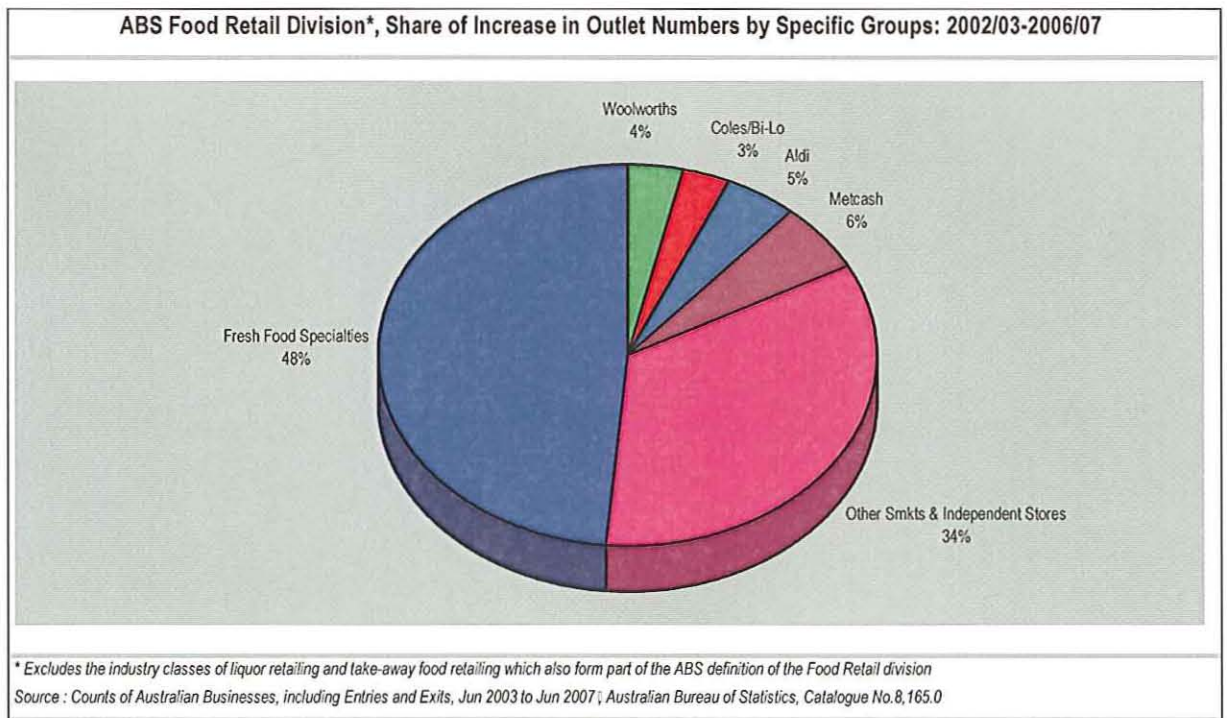


### 5.3 Woolworths faces strong competition from other supermarket operators

The competitive nature of the Australian retailing industry is also shown through the international investment in the industry, including from South Africa (PickN'Pay, now the owners of Franklins supermarkets), Germany (ALDI), Hong Kong (Dairy Farmers originally established Franklins) and potentially the US (through US giant Costco),<sup>10</sup> as well as the growing strength of Australian supermarket chains and national banners.

The chart below shows the share of increase in outlet numbers by specific groups over the period 2003 – 2007. It illustrates that fresh food specialty stores made up 48% of the increase in outlet numbers, while supermarkets and independent stores other than Woolworths, Metcash, Coles and ALDI made up 34% of the increase. Meanwhile, Woolworths contributed to only 4% of the increase in outlet numbers, compared to 6% from Metcash and 5% from ALDI.<sup>11</sup>

**Figure 19: Share of increase in outlet numbers by specific groups: 2003-2007**



A brief overview of recent developments undertaken by Woolworths' existing supermarket competitors is set out below.

- (a) **ALDI** has expanded rapidly in the space vacated by Franklins and other discounters and has captured much of the truly price-sensitive segments of the market. This aggressive growth is expected to continue, with sustained growth through increased store numbers supported by its global sourcing links. Indeed, over the period from 2002-03 to 2006-07, ALDI stores have increased from 48 to 143, an increase of 95 stores. Given ALDI's aggressive price positioning, the competitive impact of these store openings will be even greater than their contribution to the rise in store numbers.

<sup>10</sup> *Inside Retailing*, "Costco countdown", R Stockdill, February/March 2008, pages 13-15.

<sup>11</sup> Data for store numbers from Pitney Bowes MapInfo.

- (b) **Metcash/IGA** has consolidated the plethora of regional banners to a select few, particularly to the "independent" IGA/Super IGA label, for its main affiliates. The IGA banner group has improved its product offering in range and fresh produce, and has adopted their international platform of local community oriented marketing. IGA has also managed its margin mix by selling private labels (Black+Gold and IGA) competitively while charging more at standard price for premium labels.

Metcash's success is evidenced by the increased revenues reported in its wholesale operations and growth in its independent supermarket customer base. In the Foodland acquisition, Metcash acquired 60 Action stores which became part of the IGA group and increased its wholesale turnover by \$1 billion. Its strong growth is illustrated through the increase in store numbers over the past 5 years by 118 stores (from 1138 to 1256 stores), compared to an increase of only 73 stores for Woolworths and 59 stores for Coles.

In Metcash's half year results (for the period ending 31 Oct 07), it noted its intention to create a "4th business pillar", referring to its intention to provide a national network of fresh produce distribution centres by December 2008 and its intention to consider joint ventures in specific categories of meat, deli and bakery.<sup>12</sup> Notably, these are categories in which Woolworths faces strong competition from specialty stores; it is evident that Metcash's interest in entering these sectors will create an even more competitive environment. The "4th business pillar" strategy was noted in the half year results for 2007, which stated that the amalgamation of the different segments of the "Fresh" business into one business had the "potential to provide Metcash with an 'internal fourth pillar' and help grow profitable volumes..."<sup>13</sup>

Metcash's appetite for growth is illustrated through the comment that "management and the Board remain focussed on seeking growth opportunities (both organic and via acquisition)".<sup>14</sup> Indeed, as at 31 October 2007, Metcash had 1384 stores in total across its three retail channels, comprising 416 Supa IGA stores, 719 IGA stores and 249 Express stores.<sup>15</sup> For FY08, Metcash is planning to establish an additional 40-60 new stores, to extend 53 existing stores and refurbish 69 existing stores.<sup>16</sup> Metcash's ability to operate effectively and efficiently is evidenced by its reduction in its cost of doing business (CODB) by a "further 0.33% this year reflecting its continuing ability to secure supply chain efficiencies in spite of inflationary cost pressures" as a result of "ongoing strong cost control and productivity improvement".<sup>17</sup>

- (c) **FoodWorks/Australian United Retailers Limited** announced in January 2008 that it had successfully signed up the first FoodWorks stores in South Australia, enabling it to operate and compete on a national scale. FoodWorks has become Australia's second largest leading independent supermarket retailing group, with over 700 stores supporting in excess of \$1.35 billion in annual aggregate store turnover. It was created from the merger of the Foodworks Supermarket Group Ltd and Australian United Retailers in November 2004 in response to rapid industry consolidation and increased competition.<sup>18</sup>

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<sup>12</sup> Metcash, "Company Results – half year ending 31 October 2007", pages 20, 41.

<sup>13</sup> Metcash, "Metcash Limited – half year results", 4 Dec 07, page 2.

<sup>14</sup> Metcash, "Company Results – half year ending 31 October 2007", page 14.

<sup>15</sup> Metcash, "Company Results – half year ending 31 October 2007", page 16.

<sup>16</sup> Metcash, "Company Results – half year ending 31 October 2007", page 19.

<sup>17</sup> Metcash, "Company Results – half year ending 31 October 2007", page 9.

<sup>18</sup> Foodworks media release, "FoodWorks officially goes National, breaking into South Australian market", 25 January 2008.

- (d) **The Coles Group** was previously struggling to execute chosen strategies but did not sacrifice competitiveness on price as a move against potential market share loss. Under its new ownership Woolworths expects competition from Coles supermarkets to be even fiercer.

#### 5.4 Woolworths faces strong competition from specialty stores

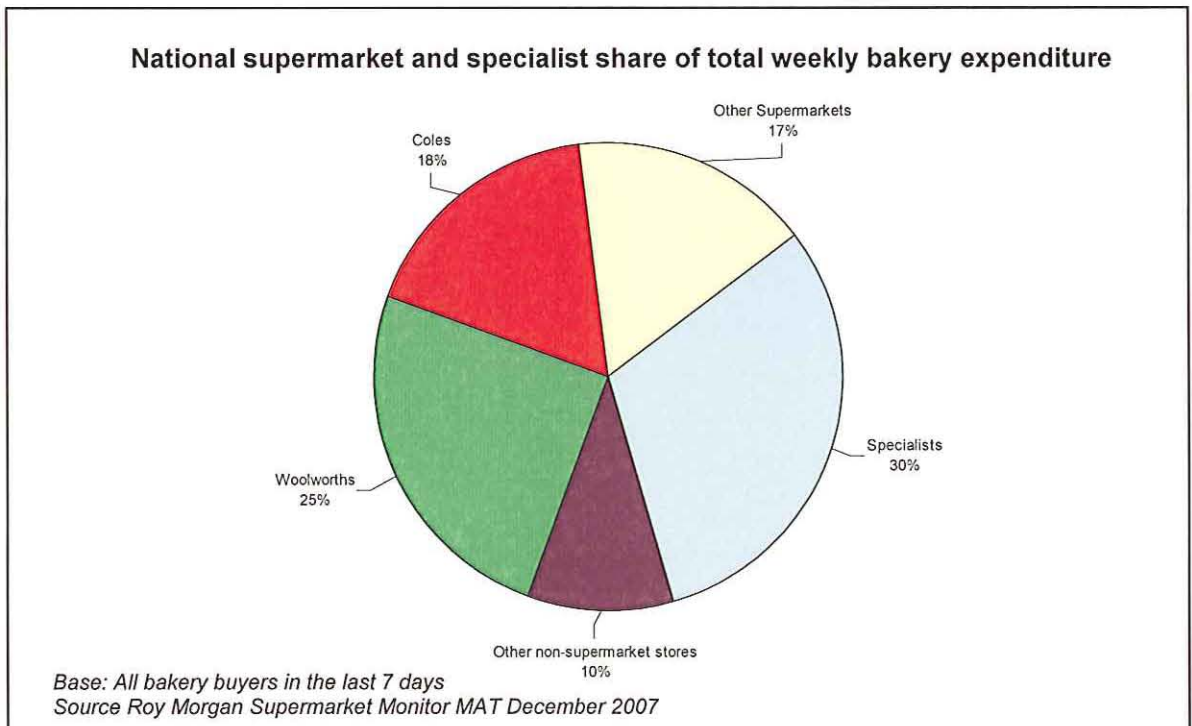
As illustrated in Figure 19 (above), specialty stores have grown in number. Indeed, over the period 2003 – 2007, fresh food specialty stores made up 48% of the increase in outlet numbers, compared to a contribution of 4% from Woolworths.<sup>19</sup>

By effectively identifying customers' specific needs, specialty stores have achieved growth and increased revenue through various strategies, including:

- increased customer sales;
- establishing successful franchise chains (for example Brumby's, Bakers Delight and De Costi Seafood);
- setting up "farmers' market" outlets; and
- broadening the retail offer to include such functions as juice bars and the capacity to cater for events (eg Michel's Patisserie).

The charts below, produced by Roy Morgan (on the basis of surveying what customers purchased over the last 7 days), illustrate how specialists have a significant share of total expenditure across the specialty departments that Woolworths caters for within its supermarkets: bakery, meat, fruit and vegetables and the delicatessen.

**Figure 20: Specialists have a significant share of total expenditure across the bakery sector**



<sup>19</sup> Data for store numbers from Pitney Bowes MapInfo.



Figure 21: Specialists have a significant share of total expenditure across the meat sector

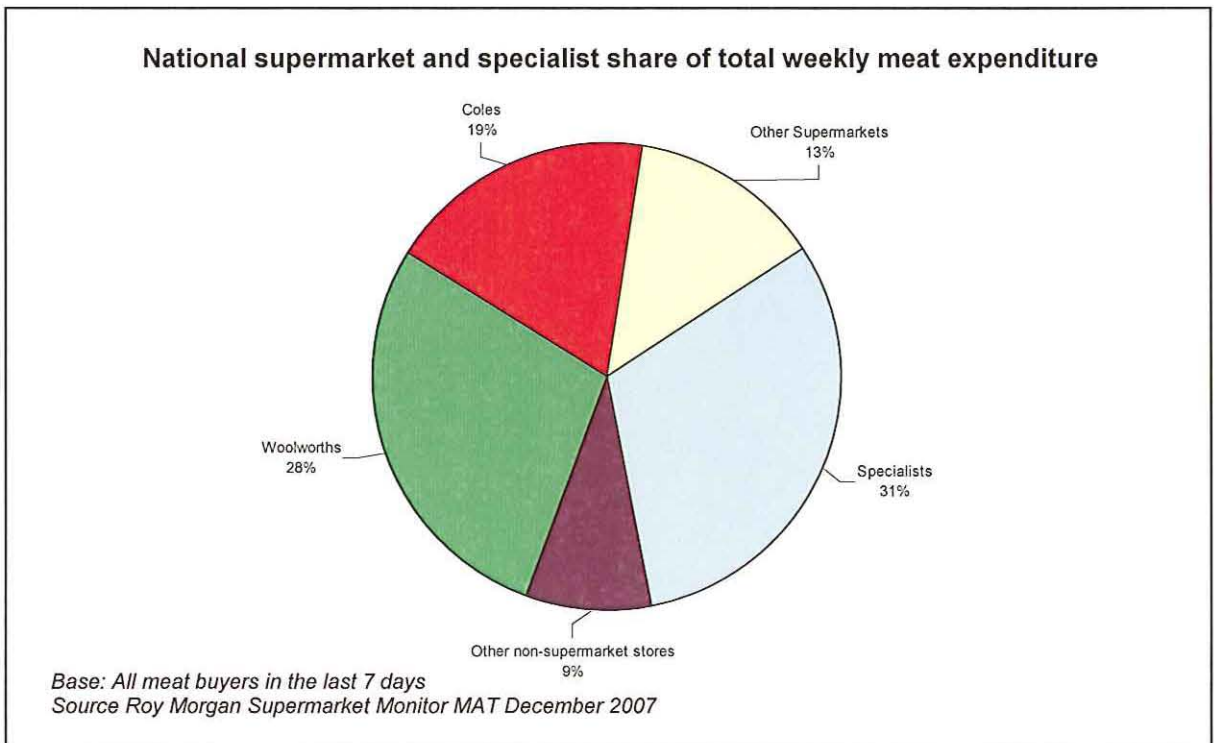
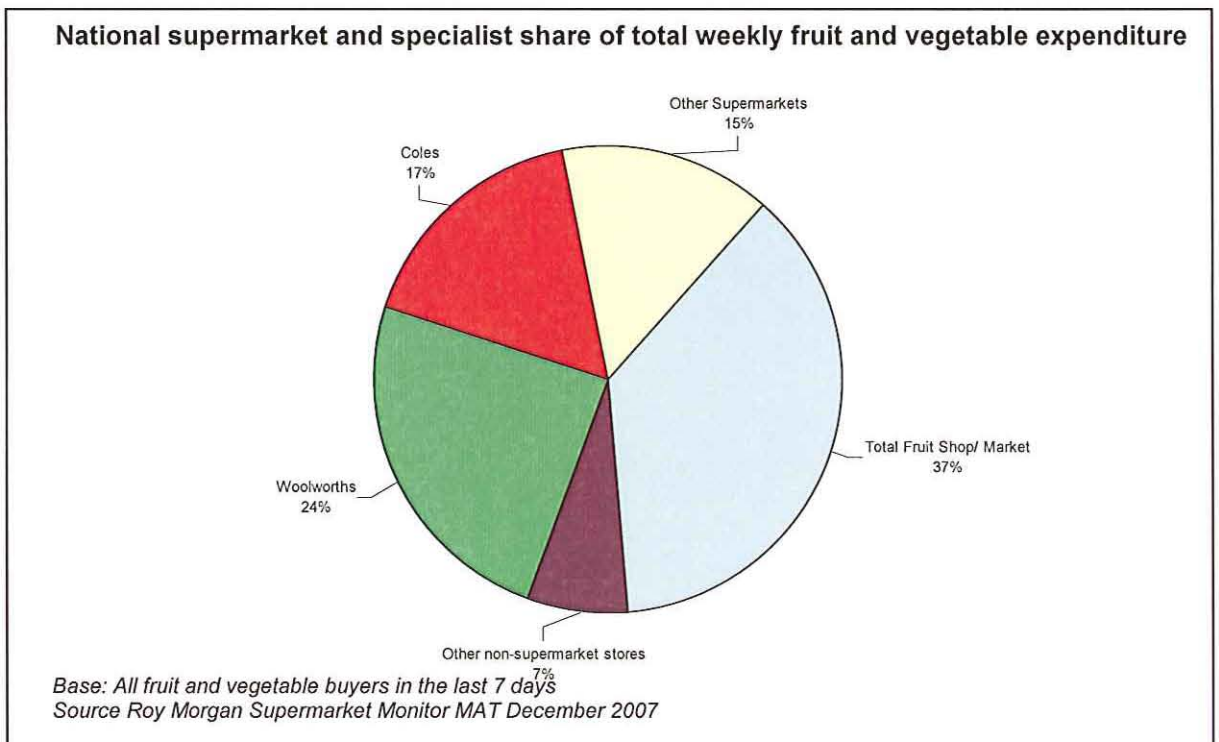
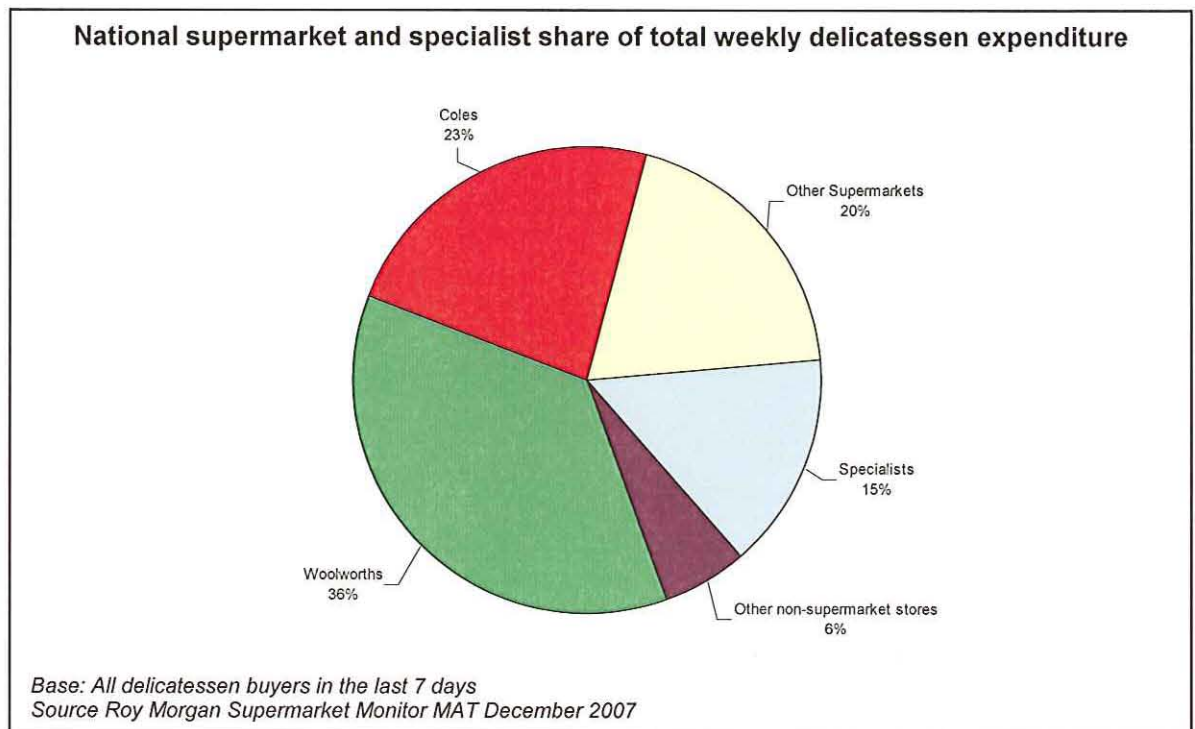


Figure 22: Specialists have a significant share of total expenditure across the fruit and vegetable sector



**Figure 23: Specialists have a significant share of total expenditure across the delicatessen sector**



**5.5 Woolworths needs to set prices competitively in order to appeal to its customers in this competitive environment**

Competitive pricing has consistently been a key factor in driving Woolworths' supermarket sales growth, and in making Woolworths an effective competitor against other supermarkets, convenience stores and speciality stores in all areas in which Woolworths operates. As stated in Woolworths' 2007 Annual Report:<sup>20</sup>

*Substantial reinvestment in lower prices has resulted in market share growth for food and grocery and has also helped maintain food price stability for consumers in the face of numerous climatic and economic pressures.*

Woolworths has operated under a low costs/low prices model for over 20 years, established under its "Fresh Food People" brand, based on providing consumers consistently with the best value basket of products, across the store and across a wide range of products. As stated in Woolworths' 2007 Annual Report:<sup>21</sup>

*Woolworths' vision is to continue to drive the retail business, bringing to customers greater convenience, quality, lower prices and better value, range, freshness and service.*

As can be seen from the above sections, the trends within the grocery industry mean that Woolworths competes with existing specialty stores and supermarket chains for the consumer dollar, and is also faced with the prospect of new entry into the Australian retail landscape by global operators. Accordingly, Woolworths needs to set its prices competitively to appeal to its customers in this highly competitive environment.

<sup>20</sup> Woolworths Limited 2007 Annual Report, page 4.

<sup>21</sup> Woolworths Limited 2007 Annual Report, page 26.