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

TO THE

AUSTRALIAN COMPETITION AND CONSUMER COMMISSION

INQUIRY INTO THE COMPETITVENESS OF

RETAIL PRICES FOR STANDARD GROCERIES – Part C

(a copy of the NARGA Submission to the ACCC on the
DRAFT 2008 MERGER GUIDELINES)[1]

March 2008

NATIONAL ASSOCIATION OF RETAIL GROCERS OF AUSTRALIA

---

[1] Submitted in support of the NARGA comments on merger control / creeping acquisitions made in our Part B Submission.

Level 5, 34 MacMahon Street
HURSTVILLE NSW 2220
Tel: 02 9580 5599
Fax: 02 9586 4777

CONTENTS

EXECUTIVE SUMMARY

The draft 2008 Merger Guidelines give a good theoretical background to a regulatory approach to the management of Section 50 of the Trade Practices Act 1974 but, in our view, do not reflect the realities of competition in the market place, as we will demonstrate.

Whilst some of the changes made in these guidelines are an improvement on the 1999 version (e.g. the deletion of any reference to a 40% market share being the trigger point for ACCC concern), the guidelines fail to adequately reflect the Object of the Act – namely 'to enhance the welfare of Australians' – as there is no mention of the public benefit, or public welfare as a consideration in the assessment of mergers and acquisitions.

We also bring to the attention of the ACCC the need to better define competition in a regional context, as many product markets have a local dimension.

We draw a number of conclusions as to the effectiveness of past processes and the extent to which any deficiencies have been addressed in the draft guidelines. We also recommend further improvements.

WHO WE ARE

The National Association of Retail Grocers of Australia (NARGA) is the peak national body representing the independent retail grocery sector in Australia. It is composed of and related to the following organisations:

- Master Grocers of Australia
- Queensland Retail Traders and Shopkeepers Association
- WA Independent Grocers Association
- IGA Retail Network
- Retail Traders and Shopkeepers Association of NSW
- State Retailers Association of SA
- Tasmanian Independent Retailers

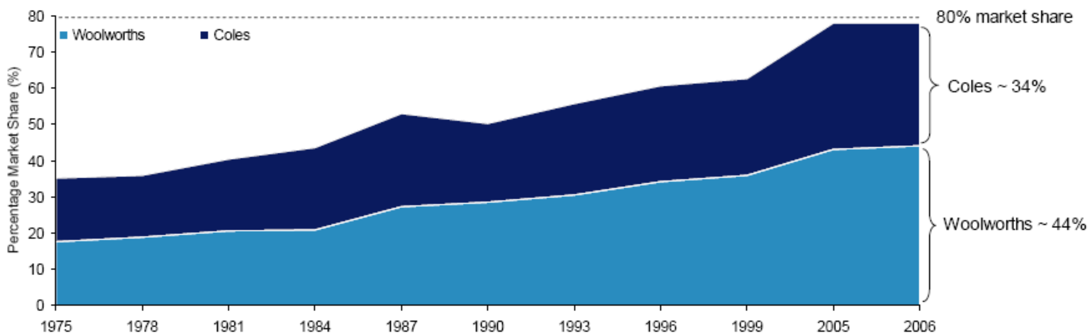
Together these represent more than 4500 small to medium sized businesses employing over 225,000 people

Retailers are at the end of a complex product supply chain and provide the interface between manufacturers and producers and the general public.

INTRODUCTION

NARGA commissioned a study of the retail grocery sector in 2007[2] which showed that since the implementation of the Trade Practices Act 1974, the retail grocery market has become more concentrated, with the two major chain's market share increasing fro 35% in 1975 to close to 80% in 2006.

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



Source: Retail World, ACNielsen

In spite of the fact that Section 50 of the Act clearly prohibits acquisitions likely to result in a substantial lessening of competition, it would appear that lessening of competition is exactly what has occurred – and not only in the retail grocery market.

Given that the clear intent of the Act is to maintain a competitive market place the question is why the Act has not been able to achieve this?

Is it the Act itself that is the problem, or the way that the Act is being administered, as evidenced by the current and draft merger guidelines?

Given the tendency towards market concentration across a broad range of markets in Australia, clearly something is not working as it should.

In our view, the merger guidelines currently in use do not sufficiently address the widely differing natures of markets and have resulted in a tendency for the regulator to take a broadly theoretical and national approach to determining merger effects, whereas many markets are clearly local in nature.

The new guidelines do not address this deficiency.

[2] The economic contribution of small to medium-sized grocery retailers to the Australian Economy, with particular emphasis on Western Australia, PricewaterhouseCoopers, June 2007

The Act requires the regulator to assess the competition aspects of a merger or acquisition at the national, state, territory and regional levels – i.e. the effects within each of these markets – not to simply decide to make the assessment on the basis of only one of these markets. Had that been done as a matter of routine, the cumulative effects of creeping acquisitions on state and national markets and market shares would have shown up as a concern long ago.

The guidelines (both current and proposed) also fail to explain that firms may be involved in a number of ***product*** markets at the same time (see comment under market definition). This implies that the competition aspects of a merger or acquisition should look at each of these markets to determine the effects of further concentration. This need is not adequately reflected in the current or proposed guidelines.

The guidelines present a view of the world through the eyes of big business, when it is quite clear that small family businesses are the main contributors to the Australian economy and employ the larger portion of Australia's workforce. Creating a fair and competitive business environment that recognises the contribution made by SMEs would appear to be one way that the welfare of Australians can be enhanced.

This submission does not comment in detail on all aspects of the draft guidelines, instead we make targeted comments on how the guidelines, and the mechanisms for the management of mergers and acquisitions could be improved

> *We conclude that the 2008 draft merger guidelines, in their current form, do not appear to be able to prevent further concentration in already concentrated market such as the retail grocery sector.*

COMMENTS ON THE DRAFT GUIDELINES

Competition

The Act does not define 'competition'. The guidelines define 'competition' as 'a state of ongoing rivalry between firms – rivalry in terms of price, service, technology, quality and consistency' – and explain that 'In a fully competitive market each market participant is mutually constrained in its pricing, output and related commercial decisions by the activity of other market participants (and) …. The market power of each market participant is limited.'

Clearly we have reached the stage in the retail grocery market where, according to this definition, the market is no longer 'fully competitive'.

This fact can be demonstrated by applying the 'competition test' to the sector. The two major chains exhibit market power as they can profitably raise prices, lower the quality of their products, reduce the range and variety of their products, lower customer service standards and change other parameters relevant to how they compete in the market. (See box p. 6 of the Merger Guidelines).

> *According to the definition of competition contained within the draft guidelines, it is clear that the retail grocery market is no longer fully competitive. The question is: what changes need to be made to the Act or to its administration to make this market more competitive.*

Market Definition

We believe that the market definition section of the merger guidelines should make it clear that a firm proposing a merger or acquisition could be active in several product markets at the one time and / or the markets that it is active in can be described or delineated in several ways.

That being the case, the regulator should examine the potential competition impacts on each of these markets, define the market share of the firm in each of these markets and the market concentration of each of those markets (according to a HHI assessment).

A case in point is the retail grocery market. The broadest definition of the market in which supermarkets operate is 'full service / full range grocery' sector. i.e. the typical supermarket provides a 'one stop' grocery shopping opportunity.

But this market can be segmented into a number of sub-sectors, the largest being the packaged grocery sector. Other sub-sectors include fresh meat, fresh fruit and vegetables, deli items, etc.

The incumbents could have a different market share of each of these sub-sectors and their market power (at each level of geographic market) then needs to be assessed.

The fact that these various sub-sectors exist has resulted in one major chain claiming, in its submission to the ACCC grocery inquiry that its market share of the grocery sector is 30% or less (rather than the 44% 2006 share identified by the AC Nielsen survey). It has simply included in its definition of the market in which it operates all outlets that sell food, including independent butchers and greengrocers, take-away food outlets, restaurants etc. Clearly that is an attempt to broaden the market definition in a manner that downplays the company's strength (market power) in the key packaged grocery sector which represents the bulk of supermarket sales.

> *We believe that the merger guidelines should clearly state that each product sector in which a firm operates is to be assessed in terms of the potential impact of a proposed merger or acquisition.*

The Concept of a Market

Whilst the Guidelines refer to the possibility that a regional market may be a substantial market under the Act, the regional or local nature of markets is not fully explored.

One of the key conclusions of the current inquiry into the retail grocery sector being conducted by the UK Competition Commission – UKCC - (and of previous UK inquiries) is that the market for retail groceries is essentially local – with shoppers unlikely to travel far to get a better deal.

The UKCC defined the local grocery market in terms of drive time isochrones – e.g. all stores within a ten minute drive time were considered to be in competition with one another - the rationale being in part the value the consumer would put on time.
This approach to the definition of market was challenged by Tesco. However the UKCC sought expert opinions from a number of sources

which support the Commission's view of the local nature of the grocery market. In particular a paper[3] by Prof. Margaret Slade of the University of Warwick shows that the competitive effect of one supermarket on another disappears after a 15 minute drive time is reached.

The local nature of the Australian grocery market is demonstrated by the reality that both major chains adjust their prices at the local level in line with the level of local competition, with higher prices in areas where there is no competition and lower prices in areas where there is a wider variety of outlets.

This analysis, taken together with the conclusions reached by the UKCC would suggest that the Merger Guidelines should more closely address the question of the local nature of markets for groceries (and a range of other products).

We also note that neither the Act nor the guidelines define the term 'region'. The issue of the importance of local markets for certain products could be addressed by inserting such a definition.

> *The Act and / or the merger guidelines should recognise the importance of the local nature of certain markets when defining markets and mergers or acquisitions within these.*

Coordinated Conduct

The merger guidelines clearly define the conditions that need to exist in a market for coordinated conduct to arise (See 5.8). We suggest that those conditions have been met in the retail grocery market where the two major chains are clearly in a position to market share.

> *The Act has been unable to prevent the development of a high degree of concentration in the retail grocery market (and other markets) nor the consequent risk or potential for tacit coordinated conduct or market sharing.*

Concentration and Market Shares

We are pleased to note that paragraph 5.95 from the 1999 merger guidelines has not been carried forward in the draft 2008 guidelines.

---

[3] UK Groceries Market Definition, Slade M. University of Warwick for UKCC, 11 September 2007

It should be noted that this paragraph sets out measures of market concentration that would result in the Commission giving further consideration to a merger proposal before being satisfied that it will not result in a substantial lessening of competition.
They can be summarised as follows:

- Post merger market share of the four (or fewer) largest firms (CR4) of 75% or more, and
- The merged firm supplies at least 15% of the relevant market, or
- The merged firm will supply at least 40% or more of the market.

The first comment to be made is our concern about the 40% post merger figure. Put simply, two firms each with a 40% market share or more form a duopoly.

The current situation in the retail grocery market is that we have, at the national level, one firm with a market share of over 40% and a second with close to it.

Although their combined market share exceeds 75% - the regulator has not acted to stop either chain acquiring additional stores.

At the local level we have grocery markets where each of the firms have a monopoly (or close enough to it), or where a duopoly, together with associated market sharing, exists.

Prices are generally lower in localities where a variety of outlets compete.

Even though local markets show a high level of concentration, acquisitions in those markets by the major chains have been approved[4].

We believe that the factors that have led to the high level of concentration we now have in the retail grocery sector include the use of the 40% threshold within the 1999 guidelines together with a lack of understanding of the need to ensure that markets remain competitive at the local level.

The draft 2008 merger guidelines still makes mention of the CR4 ratio (par. 6.16) but does not show how it is to be used in assessing a merger or acquisition. Instead the guidelines propose a greater reliance on the HHI and suggest that a HHI of greater than 2000 would be considered as indicative of a concentrated market. (See footnote p.48)

[4] This is in spite of the fact that previous guidelines have included a hypothetical monopolist (monopsonist) test

We should note here that the retail grocery market clearly exceeds a HHI of 2000. According to the market shares determined by the 2006 Nielsen data, the retail grocery market has a HHI of over 3000.

Does that mean that the ACCC will now no longer approve further acquisitions by the two majors? Or does paragraph 6.14 of the draft guidelines provide an out? This paragraph refers to 'the level of symmetry between rival firms' market shares'. Of course if we were to have two firms with 50% each, we would have perfect symmetry, but also perfect market sharing.

> *We suggest that closer attention needs to be paid to the capacity of the guidelines to prevent further concentration of the retail grocery market (as well as other markets), at both the national and local levels.*

The SSNIP Test

We note that the draft guidelines propose to use the SSNIP test to assess market power – i.e. the ability to raise prices through 'a significant and sustainable increase in price'. However the proposed ACCC general starting point for a SSNIP in the context of competition analysis is a non transitory price rise in the order of 5 to 10 per cent.

Whilst the ACCC acknowledges that 'what constitutes a SSNIP will vary depending on the circumstances, we suggest that the 5 – 10% starting point is too high.

By way of example, a 5% increase in Woolworth's grocery prices would result in the doubling of their EBIT, and a 10% increase would triple it. Even a 1% rise would increase their EBIT by 20%.

This suggests that the range is too coarse a test. A company active in a low margin market is unlikely to be able to increase prices to the extent suggested in one step, and so is likely to pass a SSNIP test set at 5 or 10 per cent – it would simply not happen.

However, it is quite likely that a company in the retail grocery sector could edge up their prices stepwise over a period of time by a much smaller percentage, particularly if the major competitor was similarly inclined, and not all prices were moved up at once.

This may well be the reason why Australian grocery prices have tended to increase at a rate higher than the CPI.

A SSNIP test set at 5% would not pick up such a trend.

It is instructive to note that the UKCC, in its analysis of market power in the UK grocery market used a much smaller price rise in its SSNIP analysis.

> *We support the use of the SSNIP test as a means of assessing market power but suggest that the test should be based on price rises smaller than 5 to 10%, particularly in the retail grocery sector.*
>
> *The fact that retail grocery prices have undergone a sustained trend of price increases in excess of CPI in recent times would suggest that the major chains have substantial market power.*

Creeping Acquisitions

The draft guidelines do not address the problem of creeping acquisition where the acquisition of additional outlets one at a time may not be of themselves indicative of a substantial lessening of competition, but taken together over time certainly result in that outcome.

We believe that the guidelines should be amended to address this issue and suggest that the ACCC has the power to do so under Section 50 of the Act which requires the regulator to consider markets at the national, state, territory or regional level.

In our view the concentration tests can be applied at each of these levels.

Given the existing level of concentration in the retail grocery market, it may be appropriate for the regulator to state quite clearly what its policy would be in relation to further acquisitions by the two major chains.

Should the ACCC feel that such a statement would not be appropriate or useful, or should it feel that the power to prevent further market concentration is not available to it under the Act, it might be appropriate for it to make recommendations to the government as to how the Act can be strengthened?

> *The current draft guidelines fail to address creeping acquisitions, which are and have been a major factor in the level of market concentration in the retail grocery sector.*

Conclusions

- *We conclude that the 2008 draft merger guidelines, in their current form, do not appear to be able to prevent further concentration in already concentrated market such as the retail grocery sector.*

- *According to the definition of competition contained within the draft guidelines, it is clear that the retail grocery market is no longer fully competitive. The question is what changes need to be made to the Act or to its administration to make this market more competitive*

- *We believe that the merger guidelines should clearly state that each product sector in which a firm operates is to be assessed in terms of the potential impact of a proposed merger or acquisition.*

- *The current draft guidelines fail to address creeping acquisitions, which are and have been a major factor in the level of market concentration in the retail grocery sector.*

- *The Act and / or the merger guidelines should recognise the importance of the local nature of certain markets when defining markets and mergers or acquisitions within these.*

- *The Act has been unable to prevent the development of a high degree of concentration in the retail grocery market (and other markets) nor the consequent risk or potential for tacit coordinated conduct or market sharing.*

- *We suggest that closer attention needs to be paid to the capacity of the guidelines to prevent further concentration of the retail grocery market (as well as other markets), at both the national and local levels.*

- *We support the use of the SSNIP test as a means of assessing market power but suggest that the test should be based on price rises smaller than 5 to 10%, particularly in the retail grocery sector.*

- *The fact that retail grocery prices have undergone a sustained trend of price increases in excess of CPI in recent times would suggest that the major chains have substantial market power.*

- *The current draft guidelines fail to address creeping acquisitions, which are and have been a major factor in the level of market concentration in the retail grocery sector.*