# Public Submission to ACCC Grocery Inquiry

by Metcash Limited

on 11 April 2008

Note: The Confidential Annexure to this submission is not for publication

# Glossary

| | |
|---|---|
| ABS | Australian Bureau of Statistics |
| ALM | Australian Liquor Marketers |
| CODB | Cost of doing business |
| CW | Campbells Wholesale |
| EBITA | Earnings before interest, tax and amortisation |
| EDLP | 'Every day low pricing' – pricing strategy emphasising relatively constant prices over time |
| Fresh Food | Fresh meat, Fresh fruit and vegetables, Bakery products, Delicatessen items |
| HHI | Herfindahl-Hirschman Index |
| Hi-Lo | Pricing strategy emphasising temporary price reductions |
| HMR | Home meal replacement |
| IGA>D | IGA Distribution |
| IGAF | IGA Fresh |
| MAT | Moving annual turnover |
| MSC | Major supermarket chain – refers to Coles Group & Woolworths / Safeway supermarkets |
| Packaged Groceries | Packaged food, Packaged non-food items, Frozen food, Dairy products |
| SKU | Stock keeping unit –particular variations of an item |
| TPA | Trade Practices Act |
| TPR | Temporary price reduction |

# Contents

# 1 Executive summary

A combination of factors over the recent years has led to rising food prices in Australia. These factors include less supply at farmgate, rising domestic and export demand for agricultural produce, increases in petrol and transport costs, higher wages and additional regulatory costs associated with new levies and improved food safety systems. However, while these factors are largely beyond the control of wholesalers and retailers, the implications of Australia's highly concentrated grocery market should be carefully examined as part of this inquiry.

### *The grocery retail market is highly concentrated*

The Australian market for grocery retailing is highly concentrated. Estimated market shares of the Major Supermarket Chains (MSCs, i.e. Coles and Woolworths) range from 74% to 80%[1] nationally. At a local level, many Australian consumers face a situation where there are no suitable alternatives to a Woolworths or Coles store within a reasonable travel distance.

Studies have shown that consumers can only look to another large, broad range supermarket (such as a Supa IGA) to provide effective competition against the supermarkets operated by the MSCs. Although 'food' is available from a wide range of retailers, including specialty shops and restaurants, large, broad range supermarkets are still central to the Australian grocery shopper. Almost all Australian consumers (98%) visit a supermarket at least once a week and the vast majority (89%) spend more money at supermarkets compared to other types of retailers.[2]

### *Independent retailers are important in maintaining competitive tension*

Maintaining competitive tension is vital to ensuring low prices for consumers and to prevent the abuse of market power by the MSCs. Independent retailers:

- help ensure that the MSCs maintain low everyday shelf pricing through their competitive presence;
- lead prices down through a heavy focus on promotions. At any point in time, roughly 2,000 – 3,000 items are on temporary price reductions, accounting for up to 40% of grocery sales volumes; and

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[1] 74% as estimated by IBISWorld in *Supermarkets and Other Grocery (except Convenience) Stores in Australia, 2008* and 80% as estimated by NARGA's report on *The economic contribution of small to medium-sized grocery retailers to the Australian economy, 2008.*

[2] ACNielsen, Shopper Trends 2008

- provide an alternative distribution outlet for suppliers and growers who may have been delisted or threatened with delisting by the MSCs.

*Economies of scale is a key advantage and must not be eroded*

The grocery supply chain is heavily dependent on achieving and maintaining economies of scale, scope and density. Over the years, Metcash has expanded in size to secure economies of scale and maintain the viability of independent retailers through:

- negotiating, and passing on to retailers, very competitive promotional deals (far superior to what individual retailers could negotiate separately), thereby allowing independent retailers to lead prices down through a heavy focus on promotions;
- offering a broad range of grocery lines at competitive prices, and thereby reducing the cost of doing business for retailers;
- offering competitive terms to all retailers; and
- replicating some of the advantages of vertical integration, for example through offering retailer support and advice, whilst still maintaining the 'independent' nature of retailers.

Acquisitions of independent retailers by the MSCs significantly undermine the economies of scale achieved by Metcash and hence undermine the ability of independent retailers to compete effectively against the MSCs.

*Independent retailers can compete with the MSCs and would expand if more suitable sites were available*

Independent retailers are successfully competing against the MSCs through their focus on strong promotions, emphasis on personal service, niche ranging to meet local customer demand and strong links to the community. In recent years, independent retailers have been successful in competing effectively with Woolworths and Coles, as evidenced by their relatively high growth rate in store numbers and comparable store sales increases.

Locational convenience is a critical requirement in opening a new supermarket. The key impediment to the expansion of large, broad range independent supermarkets (such as Supa IGAs) is a lack of access to suitable sites, due to a range of factors including:

- restrictive covenants or penalty clauses in contracts between landlords (especially shopping centres) and the MSCs, which prevent the effective entry of competitors;
- difficulties for independent retailers to gain access or approval for land outside of existing retail activity centres; and
- land acquisition activities and establishment of duplicate presences by the MSCs purely for the purpose of 'locking out' competition'.

# 2 Structure of this submission

This submission is structured as follows:

- Chapter 3 provides an overview of Metcash Limited;
- Chapter 4 provides an overview of the supply chain and structural changes in the supply chain over the recent years;
- Chapter 5 analyses the level of competition in the industry;
- Chapter 6 highlights the importance of the independent grocery retailer in adding and maintaining competitive tension in the supply chain;
- Chapter 7 provides a discussion of the way customers obtain price information and the pros and cons of unit pricing and price monitoring; and
- Chapter 8 highlights some of the factors behind rising food prices in Australia.

A confidential annexure to this submission has also been submitted.

Where parts of the submission answer questions posed by the ACCC in the issues paper, the relevant questions have been highlighted in the left margin.

# 3 About Metcash

**Figure 1: A history of Metcash**

| | |
|---|---|
| 1927 | Davids Limited establshed by Mr Joe David |
| 1995 | Listing of Davids Ltd on ASX |
| 1998 | South African group Metoz (formerly Metro Cash & Carry Ltd) acquired a 76% stake in Davids Limited |
| 2000 | Change of name from Davids Ltd to Metcash Trading Ltd |
| 2001 | Managed acquisition of 120 Franklins stores by independent retailers and integrated them into the IGA network (a key customer) |
| 2003 | Exceeded $6b in wholesale sales, market share of grocery retail market 13% |
| 2005 | Exceeded $7b in wholesale sales, market share of 13.7% |
| 2006 | Exceeded $8b in wholesale sales, 1,328 stores in IGA network (a key customer), market share of 18.1% |
| 2007 | Exceeded $9b in wholesale sales, market share of 18.6% |
| 2008 | 1,384 stores in IGA network (a key customer) |

Note: Sales refer to Metcash wholesale sales. Market share refers to share of trade for packaged groceries achieved by Metcash supplied retailers.

Metcash is a marketing and distribution company in the food, liquor and fast moving consumer goods sectors, servicing predominantly the independent and franchise grocery retail and liquor market in Australia. The company has been listed on the Australian Stock Exchange since 1995 and had a market capitalisation of $3.13 billion on 1 April 2008.

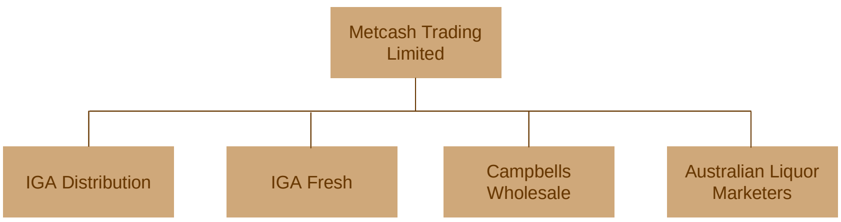
Building a strong independent retail and liquor industry is the core focus of Metcash. For Metcash to be successful, it is critical that its customers (the independent grocery and liquor retailers) are successful. Metcash continues to focus on building a differentiated competitive product offering for its independent retailers.

Metcash's vision to be "the Champion of the Independent Retailer" and complementary "Local Heroes" promotional campaign underscores its commitment to operating a unique business model which leverages the pooled volume and the entrepreneurial spirit of its independent grocery retailers.

There are over 500 million customer visits to IGA stores per annum. In comparison with the MSCs, a large proportion of the independent grocery retailers serviced by Metcash operate in the rural and regional areas of Australia. Metcash's service to those retailers has contributed to the availability of groceries in rural and regional areas at competitive prices.

## 3.1 Metcash organisational structure

**Figure 2: Metcash pillars of business**




Metcash has four pillars of business, for which it acts as a focused buying group:

- IGA Distribution (IGA>D) is a grocery wholesaler serving approximately 4,500 independent retail grocery stores (including IGA branded stores) across Australia. IGA>D operates 5 major distribution centres across 5 states, carrying dry, chilled and frozen grocery products. IGA>D supports independent retailers with a comprehensive range of services including: 24 hour retail system support, in-store training, retail store development and store equipment purchasing to assist in expanding, refurbishing or building new sites.

- IGA Fresh (IGAF) is the fresh food division of Metcash focusing on fresh food (fruit, vegetables, meat, deli and bakery) supply to independent retailers. The fresh food capability was acquired by Metcash as part of Foodland Associated Limited (FAL) and operated as a division of IGA>D until it was formally established as a separate division in November 2007. Metcash has plans to grow this business to enhance the service, quality and price proposition of fresh food to the independent grocery retail market in Australia. The number of stores serviced had reached 240 by the end of FY07.

- Campbells Wholesale (CW) is a bulk grocery and foodservice wholesaler with 3 subdivisions. Campbells Cash & Carry serves 23 major metropolitan markets and Campbells Distribution serves 19 country markets. Another subdivision of CW is Campbells C-Store, which primarily services the modern franchised petrol and convenience market such as 7-Eleven stores. CW caters to some 70,000 small business customers providing a wide range of products (groceries, tobacco, liquor, confectionery, and foodservice lines).

- Australian Liquor Marketers (ALM) is a broad range liquor wholesaler, supplying over 14,500 hotels, liquor stores, restaurants and other licensed premises throughout Australia and New Zealand. ALM operates from 21 distribution locations across the country. Larger ‘off-premise’ customers are supplied through the main distribution system; a specialist ‘on-premise’ distribution arm, Harbottle On-Premise (HOP) supplies pubs, clubs and restaurants. ALM also provides marketing support and a range of services to assist their customers grow their business.

Financial information for each division is presented in the table below.

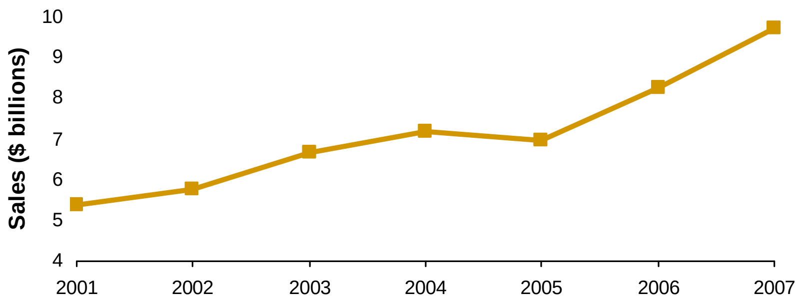
**Table 1: FY07 Financial information for Metcash by division**

| FY07 ($bn) | IGA>D | IGAF | CW | ALM | Metcash Total |
|---|---|---|---|---|---|
| Wholesale Sales | 5.82 | (1) | 1.42 | 2.45 | 9.69 |
| EBITA | 0.25 | (1) | 0.03 | 0.03 | 0.30 |
| EBITA % | 4.25% | (1) | 2.04% | 1.16% | 3.14% |

(1) Sales and EBITA for IGAF included in IGA>D for FY07

Figure 3 below illustrates the strong sales performance of Metcash. This performance is a direct result of Metcash's focus on supporting and growing the independent retail sector which it serves.

**Figure 3: Metcash historical sales FY01 – FY07**




## 3.2 Metcash's distribution model

Grocery retailers can purchase products from each of the 3 business units in 2 primary ways:

- purchase direct from the Metcash warehouses; and / or
- purchase directly from suppliers, with the purchase cost settled with Metcash (charge-throughs).

Metcash purchases its products from 4 sources:

- the farmgate (fresh food only);
- markets (e.g. Flemington);
- domestic manufacturers/suppliers; and / or
- overseas manufacturers/suppliers.

Metcash provides value for its customers through its ability to obtain competitive prices from suppliers, its extensive distribution network, its service and the quality of its support for its customers' businesses.

## 3.3 Key independent grocery retail customers

Metcash services a wide range of independent grocery retail customers, of which some are discussed below.

### IGA Network

The IGA network is a key customer of Metcash. IGA supermarkets are independently owned, and operate in 3 formats as shown by Table 2 below.

**Table 2: IGA network overview**

| Format | No. Stores | Key Market | Avg. floor space | Avg SKUs |
|---|---|---|---|---|
| Supa IGA | 416 | Major shop (e.g. weekly/fortnightly) | 1,400m2 | 25,000+ |
| IGA | 719 | Top-up shops | 600m2 | 12,000 |
| IGA Express | 249 | Convenience | 220m2 | 3,000 |

IGA supermarkets (except those in WA which operate under franchise agreements) are licensed to use the IGA brand via an Alliance Agreement, which governs:

- brand and marketing compliance; and
- supermarket operating standards.

The total annual turnover (at retail) of the IGA Network is approximately $7.7b (FY07).

The key competitive advantages of the IGA Network include:

- Price. IGA stores are competitive on price, and run strong promotions.
- Convenient shopping (quick in, quick out). IGA stores are conveniently located with convenient operating hours.
- Niche ranges. Independent operators have a strong understanding of the community they operate in and therefore

are able to stock ranges that are tailored to the community's tastes.

- Personal service to customers. The employees at the stores make particular effort to be able to provide friendly and personal service to their customers.

- IGA Community Loyalty Programs. Each IGA store makes donations to its community through setting aside a certain percentage of sales from selected lines/products. This money is then donated to a charity or community organisation that is chosen by the independent operator or his or her customers.

As the 'Champion of the Independent Retailer', Metcash is committed to supporting independent retailers by providing a comprehensive range of services, such as:

- Retail system support for point of sale and back office computer systems;

- A variety of marketing support programs, designed to enhance the IGA Brand experience for end-consumers. These include community support initiatives, sponsorship programs, healthy living and wellbeing initiatives, public relations programs etc;

- In-store retail training;

- A range of specialist service personnel including channel, business and fresh food managers; and

- Retail development and store equipment service to assist in expanding, refurbishing or building new sites.

Analysis of IGA retailer purchasing demonstrates that approximately 70% of all IGA purchases are through Metcash (either through direct purchases from the Metcash warehouse, or charge-throughs). The remainder of the supplies are sourced from alternate sources such as fresh markets or other suppliers. Where the IGA retailer has a liquor outlet (465 retailers), this is supplied by ALM.

## FoodWorks

Metcash is the primary supplier of FoodWorks, which is serviced by the IGA>D division. FoodWorks operates under an independent model, where the owners of the stores are also shareholders of the group. The head office of FoodWorks provides services to its members similar to those provided by Metcash to its IGA branded stores. FoodWorks has approximately 700 stores nationally and turnover of approximately $1.6bn annually. Metcash has entered into a supply contract with FoodWorks and supplies FoodWorks stores via IGA>D.

## Foodland IGA

Metcash also supplies Foodland IGA stores which are located throughout South Australia, Broken Hill and the Northern Territory. Foodland IGA operates as a stand alone marketing house under the IGA umbrella. Foodland IGA stores are independently operated supermarkets.

## 7-Eleven

Metcash, via Campbells C-Store Distribution division, has entered into a supply contract with 7-Eleven. 7-Eleven stores are convenience stores operating under a franchise model with a large number of independent owners. There are currently more than 360 7-Eleven stores located in Victoria, New South Wales and Queensland. Approximately half of these stores also sell fuel.

# 4 The Australian grocery supply chain

Over the past 5-10 years,

- mergers and acquisitions have driven the retail market to become increasingly concentrated;
- the entry of the discount retailer Aldi has influenced other retailers to promote their own range of private label products;
- petrol shopper docket schemes are widely used by consumers and have influenced consumer choice in petrol retailers; and
- the need to secure economies of scale in the non-vertically integrated wholesale market has led to the emergence of Metcash as the primary supplier of packaged groceries for independent retailers.

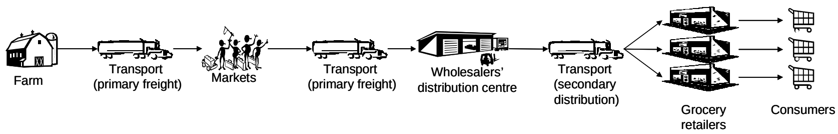
## 4.1 An overview of supply chain functions

Q17 Identifying each of the steps in the supply chain from supplier to retailer.

Q18 The activity or value added in each step.

Q19 The businesses or business types that undertake each activity.

Figure 4 and Figure 5 below show the typical supply chain for fresh




food and manufactured or processed products.

**Figure 4: Typical supply chain for fresh food**

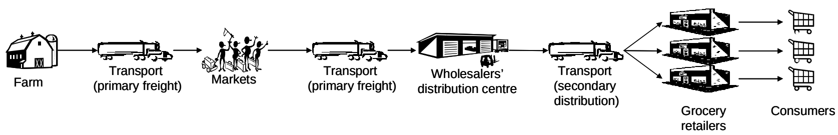
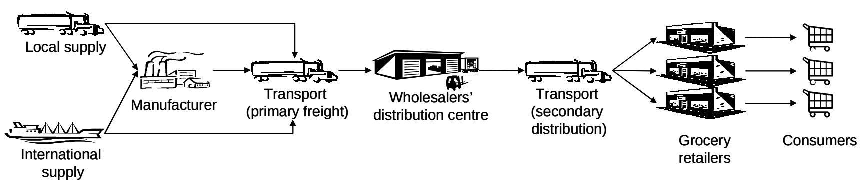



**Figure 5: Typical supply chain for packaged groceries**



Q12. In what ways (if any) do grocery wholesaling operations and arrangements differ by product categories? Please provide details.

The steps in the supply chain for fresh and packaged products are similar, with the exception that fresh food may be transported to markets prior to entering a distribution centre. There is also a larger degree of delivery direct from manufacturer/farm to store for Fresh product.

Grocery retailers sometimes also source products directly from manufacturers or farmers.

The table below categorises the product types or categories listed in the ACCC's issues paper into either "fresh food" or "packaged groceries". These are not absolute classifications as some products would fall under "packaged groceries" despite being a fresh food.

**Table 3: Product category classifications**

| Fresh food | Packaged groceries |
|---|---|
| Fresh meat | Packaged food |
| Fresh fruit and vegetables | Packaged non-food items |
| Bakery products | Frozen food |
| Delicatessen items | Dairy products |

There are 4 main functions in the grocery supply chain, all or some of which may be carried out by a vertically integrated player. Each of these functions is discussed below.

## Primary producers

Primary producers are those businesses engaged in agricultural activities to supply their products to end consumers. These products may be processed or consumed fresh. In Australia, there are over 111,000 commercial farms and firms engaged in agricultural food production.[3]

Individual primary producers often form co-operatives (such as Biological Farmers Co-operative Ltd, Fonterra Co-operative Group Ltd and Batlow Apple Co-operative Ltd), where their individual outputs are pooled and sold. The co-operative may also provide marketing and business support services for its members. Any surplus in profits is distributed to the producers through dividends. Through the use of a co-operative, individual farmers can achieve economies of scale that would otherwise be unavailable to them.

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[3] Department of Foreign Affairs and Trade, 2008

Fresh food traditionally has been made available to consumers through channels such as greengrocers and fresh fruit and vegetable markets. However, as supermarkets have been expanding their range of fresh food over time, customers have increasingly purchased fresh food from supermarkets. As of February 2008, 73% of fresh food purchased by Australian consumers was purchased from supermarkets[4].

Primary producers can sell their products through 4 channels:

- direct supply to retail outlets (the MSCs, Independents, butchers, etc);
- supply to markets that aggregate volumes from the farmgate for on-selling;
- direct supply to wholesalers/MSC distribution centres; and
- as input to food manufacturers.

## Grocery manufacturers

Manufacturers engage in further processing of materials provided by primary producers and other suppliers of raw materials to produce products that meet consumer demand. Manufacturers also invest in research and development to ensure their goods continue to meet changing consumer demands.

Except in the case of private label products, grocery manufacturers will also carry out marketing, promotion and brand building activities, often in conjunction with retailers.

Manufacturers can sell their products through 2 primary channels:

- direct supply to retail outlets (the MSCs, Independents, butchers, etc); and
- supply to wholesalers/MSC distribution centres.

There are a wide range of domestic and foreign manufacturers who supply the Australian grocery market. For example, key manufacturers of carbonated soft drinks include Coca Cola Amatil, Cadbury Schweppes, PepsiCo and a range of minor players.

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[4] ACNielsen, Nielsen Homescan, 2008

## Grocery wholesalers

Wholesalers add value to the grocery supply chain by engaging in purchasing, warehousing and distribution activities and acting as an interface between primary suppliers and manufacturers and grocery retailers.

The value add of the wholesaling function is that it simplifies the customer relationship – the supplier can interact with one customer (the wholesaler) rather than many different retailers. From a customer perspective, the wholesaler provides the customers with access to the full range of grocery products in one location. Furthermore, wholesalers act as aggregators of volume to:

- obtain better purchasing terms than would otherwise be available to individual customers;
- gain critical mass to enable investment in supply chain and/or IT solutions; and
- optimise / streamline the distribution network to offer a cost competitive route to the independent grocery retailer.

The MSCs operate as vertically integrated wholesaler/retailer entities with the advantage of being able to centrally control a range of functions across the wholesale and retail network.

Sophisticated wholesalers such as Metcash try to replicate the MSCs' networks and the benefits of vertical integration while maintaining an independent retail model, by providing additional services for their customers including:

- merchandising (e.g. range planning, planograms, customer analytics);
- promotions (e.g. rolling promotional programs, distribution of catalogues, negotiating joint promotions with suppliers);
- retail support (e.g. business management support, training initiatives, retail consistency and compliance checks, etc); and
- private label brand building and coordination of private label contracts.

This has the effect of increasing the overall competitiveness of the independent wholesale and retail network.

### Grocery retailers

Grocery retailers act as the interface with consumers by stocking and displaying products in an appealing manner. As such, grocery retailers are closest to the end consumer and changing consumer demands reflected through retail sales. Manufacturers and wholesalers then seek to respond to these changing consumer demands through innovation.

There are a broad range of businesses in Australia that carry out retailing activities, including supermarkets (Woolworths, Coles, Supa IGA, etc); specialty retailers such as butchers, seafood retailers, fruit and vegetable shops; local markets, and convenience stores.

Goods can be sourced by grocery retailers in two primary ways:

- Direct purchases from wholesalers/MSC distribution centre; and / or
- Direct purchases from primary producers and manufacturers.

## 4.2 Structural changes in retailing

Q3 What have been the major changes to the structure of grocery retailing in Australia over the past 5 to 10 years?

Q4 What factors have driven these changes (e.g. changes in trading hours, one-stop convenience of supermarket shopping, mergers and acquisitions, etc.)? What has been the relative importance of these and other factors?

Q60 Have there been acquisitions of independent stores by the MSCs in the past three years that have not been brought to the ACCC's attention and are not listed in Attachment A?

Over the past 5-10 years there have been a number of changes in the retail market.

### Increasing concentration in the retail market

Mergers and acquisitions over the past 5-10 years have contributed to the continued increase in the combined market share of the MSCs. The packaged groceries market share of Coles and Woolworths is estimated to range from 74% to 80% (please see Chapter 5), compared to approximately 66% in 1998.[5]

Continued consolidation in the industry through mergers and acquisitions is the most important factor that has led to the current level of market concentration. Significantly, Coles purchased 16

[5] Grocery retail market shares (dry/packaged goods only) for Woolworths and Coles, as calculated by ACNielsen, Parliament of Australia Joint Select Committee on the Retailing Sector, 1998

Charlie Carters supermarkets in 1998 while Woolworths purchased 67 Franklins stores in 2001 and 22 Action stores in 2005.[6]

In addition to those acquisitions listed by the ACCC in its issues paper, Table 4 below details other supermarket acquisitions that have been made since 2005 which were not examined by the ACCC.

**Table 4: List of supermarket acquisitions not listed in Issues Paper**

| Acquirer | Target | Retail Area (square metres) | Annual Retail Sales ($m) |
|---|---|---|---|
| Woolworths | Supa IGA Coonabarabran | 1000 | 11 |
| Coles | IGA Wyong | 1300 | 8 |
| Woolworths | Supa IGA Bathurst | 1800 | 9 |
| Franklins | Supa IGA Ulladulla | 1600 | 6 |

Q7 Please provide details of recent entry and exit in grocery retailing including the reasons for the success or otherwise of new entry and the reasons for exit

There has been no large scale entry of an effective competitor against Coles and Woolworths over the last decade. The 'third force' in the industry is still the independent retailers, in particular the large, broad range supermarkets such as Supa IGAs. Aldi, which entered the market in 2001, does not directly compete with the MSCs as it offers a very narrow range and does not carry many branded products.

## An increase in private label products

Q79 How has the sale of private-label or generic products by grocery retailers changed in recent times?

The entry of the discount retailer Aldi, which focuses heavily on private label products, has influenced the decision by other retailers to promote their own range of private label goods. Private label sales as a share of defined packaged groceries have grown from 16% in 2002 to 19% in 2006[7].

A key incentive for the promotion of private label products by grocery retailers is that the retailer has greater control over (and typically obtains higher gross margins from) private label products compared

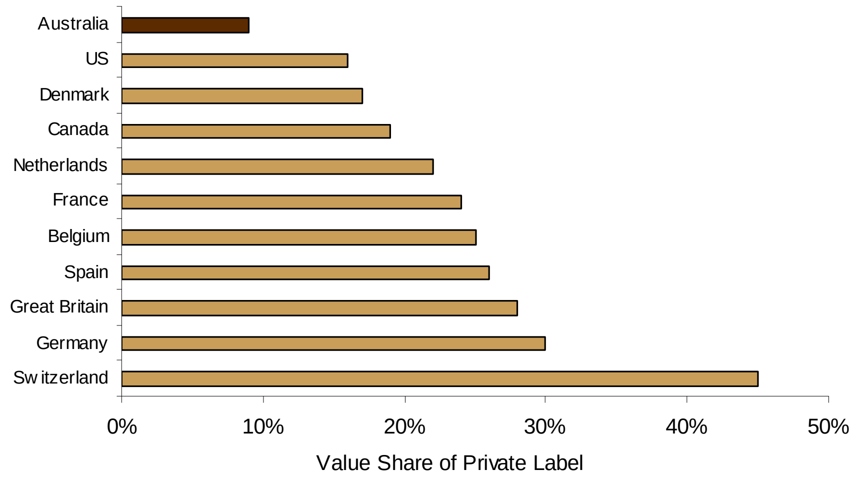
6 IBISWorld, Supermarkets and Other Grocery (except Convenience) Stores in Australia, 2008

7 Based on Nielsen Homescan data, ACNielsen, Shopper Trends 2006

to branded products. The retailer's store brand equity can also be leveraged to extend the retailer's private label product offerings (and vice versa).

Figure 6 below illustrates that private label sales in Australia have lagged behind most European countries.

**Figure 6: Private label value share, 2005**




Source: ACNielsen, The Power of Private Label, 2005

Private label products also tend to be more prominent in countries where the retail market is concentrated, as an ACNielsen report into private labels found that "of the ten most developed Private Label countries, nine had retailer concentrations (share of sales held by top 5 retailers) over 60%".[8] Sales of private label products are expected to grow in the future as they gain more presence in supermarkets.

## Changes in the operation of independent retailers

Traditionally smaller outlets (such a corner stores) were able to open for longer hours compared to larger supermarkets, allowing them a 'convenience' related comparative advantage. However, following the progressive deregulation of trading hours in many Australian states, larger supermarkets were able to offer the same, if not longer, trading hours as smaller outlets. This has led many smaller outlets to focus on a differentiated product through other means including niche ranging and personalised service.

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[8] ACNielsen, The Power of Private Label, 2005

The continued increase in disposable income, with the mean weekly disposable income increasing from $476 in 1995/96 to $644 in 2005/06[9], has lead to increased demand for value added products, new product varieties, and higher quality goods and services. These changes have tended to favour the specialty gourmet retailers that focus on quality and innovation as well as the larger supermarkets that are able offer a wider range of products.

These changes, along with the significant economies of scale, scope and density that apply to the grocery retailing industry, have contributed to a greater number of independent retailers operating under banner groups. Currently, there are around 1,384 stores in the IGA Network.

## Introduction of petrol shopper dockets

Q30 How effective are shopper dockets schemes (such as petrol shopper dockets) in attracting customers? What is the incidence of the use of petrol discount vouchers? How do the supermarket chains fund petrol discounts? Are the discounts funded from higher grocery prices? Is there any evidence of petrol shopper dockets schemes affecting grocery prices?

Q58 What impact have petrol shopper docket schemes had on small and independent grocery retailers? If shopper dockets are not offered, does this affect the ability to compete with the MSCs?

Q59 Have independent grocery retailers attempted to implement their own petrol discount schemes or other discount schemes? What has been the success of those schemes?

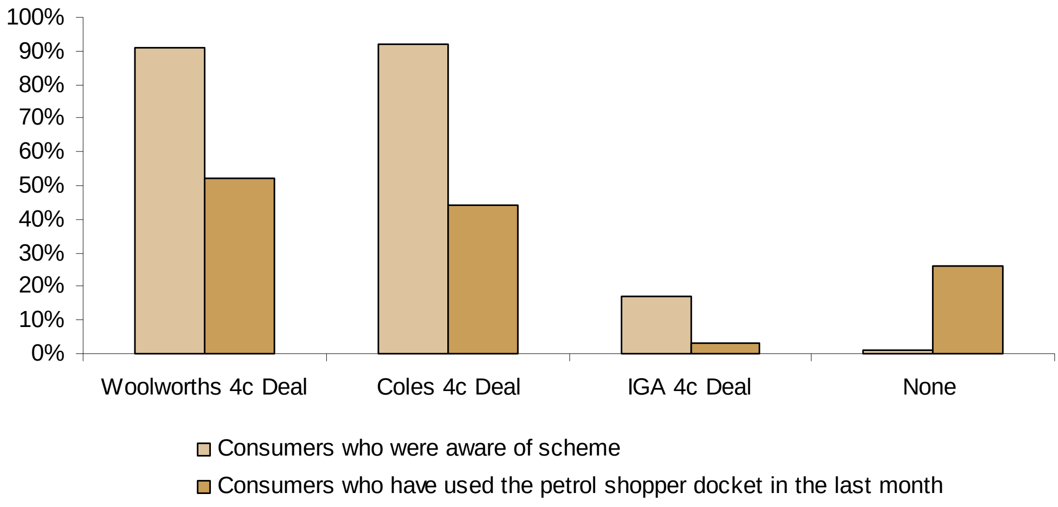
Petrol shopper docket schemes, which involve a fixed discount per litre of petrol following the purchase of a certain amount of groceries, were first introduced by Woolworths in 1996 and then widely adopted in the industry in the last 10 years. The volatility of petrol prices as well as the rapid increase in its price has led to the strong success of the scheme.

In Australia there are specific linkages between particular supermarkets and particular petrol retailers. For example, Woolworths has entered a long term arrangement with Caltex, while Coles is associated with Shell. In contrast, some independent retailers under the IGA banner offer a 'reverse scheme' whereby they offer a discount on their customers' grocery bills upon presentation of a receipt from *any* petrol outlet.

The schemes introduced by Coles and Woolworths have been very successful. The following figure shows that over 90% of consumers are aware of the existence of petrol shopper docket schemes and less than a quarter of consumers did not use a petrol shopper docket in the month before the survey.

[9] Equivalised disposable household income – all persons, ABS, 65230DO001 Household Income and Income Distribution, Australia, 2005-06

**Figure 7: Awareness and use of petrol deals offered by retailers in November 2007**




Source: ACNielsen, omnibus survey on petrol discount offers, November 2007

Q34 Has the move by Coles and Woolworths into petrol retailing and the adoption of petrol shopper docket schemes altered competition between the MSCs and competition in grocery retailing more broadly? If so how?

The 'bundled' schemes offered by Coles (with Shell) and Woolworths (with Caltex) are different the 'reverse scheme' offered by independent retailers under the IGA banner. The 'reverse scheme' which offers a discount for petrol purchased at *any* petrol outlet, and this scheme has a number of advantages in preserving competition:

- The 'reverse scheme' preserves competitive pressure in the petrol retailing market, as it is not aligned to any specific petrol company and hence, does not create challenges for those petrol retailers not aligned with the supermarkets.

- A 'bundled' scheme could allow retailers to raise their headline prices while still retaining customers through the scheme that offers a low 'bundled' price overall.[10] For example, Shell could raise the price of petrol by less than an average of $2 per week per customer, but still retain the majority of customers who use the Coles / Shell shopper dockets and save more than $2 per week, at the detriment of customers who do not use the dockets. This would not be possible under the 'reverse scheme', and hence it protects those customers who do not use petrol shopper dockets.

- An 'unbundled' scheme does not create artificial price dependencies between the grocery retailing and petrol retailing industry. The customer is free to choose whichever

[10] Gans, J., King, S., Supermarkets and Shopper Dockets: The Australian Experience, The Australian Economic Review, vol. 36, no.3, pp.311-16, 2004

petrol retailer he or she prefers, rather than being locked into a 'bundled' purchase of petrol and groceries.

If the cost of the bundled scheme is shared between the petrol and grocery retailer, this can raise barriers to entry for grocery retailers – any new entrant into grocery retailing must not only provide competitive grocery prices but also provide customers a discount for their petrol purchases. This would be difficult if there were no major petrol retailers left in the market to partner with in offering a 'bundled' scheme. In its December 2007 report on petrol prices, the ACCC recognised that "no competing (petrol shopper docket) scheme can have the pulling power of the two main supermarkets".[11]

## 4.3 Structural changes in wholesaling

### Consolidation in the non-vertically integrated wholesale market

Q10 What have been the major changes to the structure of grocery wholesaling in Australia over the past 5 to 10 years?

Q11 What factors have driven these changes (such as cost savings from large-scale wholesaling operations, changes to the structure of grocery retailing, mergers and acquisitions, etc.)? What has been the relative importance of these and other factors?

Wholesaling activities, namely of purchasing products from suppliers, providing storage at warehouse facilities and the distribution of products to retail stores, are carried out in the Australian grocery supply chain by both vertically integrated and non-vertically integrated entities.

There has been significant consolidation in the non-vertically integrated wholesaling market, driven by the need for significant scale economies in order to maintain a low cost base for retail customers.

One example is that of Australian Independent Wholesalers (AIW), whose key customer was Foodworks. As a result of a decision by Foodworks to use Metcash as its primary supplier in 2002, AIW made a strategic decision to close its operations and sell its Queensland warehouse to Australian Retail Logistix Limited. As Foodworks was the major customer of AIW, this resulted in significant losses in economies of scale that undermined the viability of AIW.

[11] ACCC, Petrol prices and Australian consumers, December 2007

# 5 Level of competition in the market

The relevant market should be defined on the basis of consumer choice, which is limited when it comes to packaged groceries. Australian consumers are still heavily dependent on supermarkets.

The grocery retailing market is dominated by Woolworths and Coles. Together, the MSCs have market share of around 74% to 80% nationally, and this is even higher on a local level.

Overseas experience suggests that Australia's population should be able to sustain at least three large retail chains, but lack of access to sites is a key impediment to the large scale expansion of independent retailers.

Economies of scale are vital in maintaining a competitive cost base for independent retailers – further acquisitions of independent retailers by Woolworths and Coles would undermine the cost base of independent retailers and erode the level of competition in the market.

Independent retailers are competitive against the MSCs, despite anecdotal evidence of a difference in the confidential supplier terms obtained by Metcash compared to the MSCs. The competitiveness of independent retailers is evidenced by the strong growth in the number of new store openings by independent retailers.

Ongoing competition between firms in the grocery supply chain is vital to constraining the ability of any firm to profitably raise prices, or lower service quality without a reduction in price. The ACCC itself often characterises an increase in market power as the ability to raise prices.[12] The level of concentration in a market is an important consideration in determining whether any players hold market power.

[12] ACCC, Draft Merger Guidelines, 2008

## 5.1 Defining the retail market

Q6 What are the most appropriate ways of measuring the shares of grocery retailers (value of sales, number of stores, areas of floor space, etc.)? Should industry or market shares be measured across all grocery items or for particular product categories (such as packaged food, bakery products, meat, fruit and vegetables, delicatessen products, etc.)? If possible, please provide quantitative estimates of shares of grocery retailing detailing the data sources and any assumptions made in estimating the shares. How have these shares changed over the past 5 to 10 years?

Q22 What options or choices of retailer do consumers have to purchase grocery products? How far will customers travel for their groceries? How does this differ by grocery product (packaged food, meat, fruit and vegetables, etc)? How does this differ depending on the type of shopping trip (weekly shop, top-up purchases, etc)?

Q24 How important to consumers is the convenience of purchasing from a retailer offering a broad range of grocery products (meat, fruit and vegetables, packaged products, etc)?

Q26 How important are factors such as distance of travel, freshness of perishable items, product range, etc? Does this differ depending on the grocery product? If so, how and why?

Q33 To what degree do Coles and Woolworths compete against each other? To what degree does the option of shopping at other supermarket chains (e.g. IGA) constrain the conduct of the MSCs? To what degree does the option of shopping at specialist grocery retailers constrain the conduct of the MSCs? To what degree does the option of shopping at convenience stores constrain the conduct of the MSCs? How does this differ by product group? How does this depend on the type of shopping trip (i.e. weekly or "top-up")?

It must be noted that when we speak of power, shares or concentration, we speak of these things "in markets". The definition of the market takes on crucial significance. Obviously, the larger the market that is defined, the lower the concentration or share of a particular player resulting in the appearance of a lower degree of market power. This leaves open the opportunity for powerful players to manipulate the definition of relevant markets to mask their true power in a market or markets.

As a result of the enormous disparity in market definition seen in previous inquiries and the likelihood that such disagreement will resurface in the current inquiry, it is necessary to go back to first principles and examine the ACCC's Merger Guidelines. The ACCC's Merger Guidelines[13] describe the concept of a market as "the space in which rivalry and competition take place". This is focused on the buyers and sellers who effectively constrain the pricing and output decisions of the relevant players.

A common misconception about the retail market is about the 'product' that retailers produce. The actual grocery items are not outputs of the retailers – they are the outputs of manufacturers and primary producers. The 'product' offered by retailers is access for suppliers to the customers, and access by customers to a range of merchandise and associated services including parking, payment facilities, customer service, etc[14].

It is important to understand that the retail market refers to the retailing activity (the "value bundle" of the retail offer including convenience, range, service, etc) and not the merchandise itself (the grocery items). Therefore, although food is available through a wide range of outlets (pubs, restaurants and cafes, supermarkets, convenience stores, specialty retailers, etc), they should not all be considered as part of the same market unless the consumer views the "value bundle" each outlet offers as close substitutes.

The enormous impact of different market definitions on the corresponding market share was seen in the report of the Joint Select Committee on the Retailing Sector in 1999 – depending on

[13] Published in 1999 and draft published in 2008

[14] Smith, R.L., The Australian Grocery Industry: A competition perspective, The Austrlaian Journal of Agricultural and Resource Economics, 50, pp33-50, 2006

the market definition used, submissions by different players showed the joint market share of the MSCs ranging from around 43%[15] to over 80%.[16]

Demand side substitution is the key focus of Metcash's analysis of market definition for grocery retailers. The willingness of consumers to switch to other stores is an important factor in determining the boundaries of a market. For customers, important considerations in their choice of retailers include:

- geographic area, as "the perishable nature of groceries and the frequency of shopping trips make location and convenience critical factors in the choice of where to shop"; and.[17]
- the retail offer, as there are many differentiating factors between grocery stores including price, range of products, quality of products, store layout, food counters, cleanliness, parking facilities and opening hours.[18]

These factors were confirmed in the recent UK Competition Commission (UKCC) analysis of the UK groceries market, which recognised that grocery retailing stores differ from one another by their price, range of products, quality of products, store layout, food counters, cleanliness, parking facilities and opening hours.

Trade sector classifications adopted by the industry typically distinguish between supermarkets (Woolworths, Coles, Bi-Lo, Franklins, IGA, Action, Aldi, and others including Spar, Four Square, Food for Less), and non-supermarkets made up of department stores (David Jones, Myer, etc), mass merchandisers (K-Mart, Big W, etc), convenience stores (Shell Select, Coles Express, etc) and specialty retailers (butchers, chemists, etc).

Even within the supermarkets category, there are marked differences in the retail offer between different supermarkets. As a proxy for classifying which supermarkets are a satisfactory substitute for other supermarkets, the UKCC categorised stores based on their size into large (over 1,400 square metres), mid-sized (280-1,400 square metres) and convenience (less than 280 square metres) stores. Size was selected as a proxy because it:

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15 Refers to all food and grocery spending in Australia. Senate Committee, Retailing Sector Report, 1999

16 Refers to dry / packaged grocery market. Senate Committee, Retailing Sector Report, 1999

17 Walker et al, Retail Grocery Prices in Victoria: The Relevance of Local Market Conditions, The Australian Economic Review, vol. 37, no. 3, pp. 317–28

18 UKCC, Groceries Market Investigation Provisional Findings Report, 2007

- is correlated to the number of product lines or SKUs available – the larger the store, the greater range of products available;
- is correlated to the availability of different food counters and other store amenities– usually, larger stores provide a greater number of food counters and amenities such as car parking, ATMs, etc; and
- is correlated to the average expenditure per shopping trip – a significant proportion of large shopping trips are conducted in larger stores.

The size of the store is thus important in considering whether a store can be considered a close substitute to another store. Only larger supermarkets such as a Supa IGA should be considered a close substitute to a Woolworths or Coles supermarket.

Within stores of a similar size, store fascia (branding, logos and graphics to establish the retailer identity) is used by retailers to communicate messages to customers about the type of service customers are likely to encounter, the helpfulness of staff, the freshness of products and many other factors. The most important message that fascias can communicate is with regards to the range and type of products - some provide a full range grocery offering, while others provide a more limited range of products as part of their business strategy which is independent of the constraints imposed by store size. The UKCC found that limited range discounters (such as Aldi) were not considered close substitutes to those full range retailers operating similar sized stores.[19] The UK experience is significant for Australia as Aldi and other limited range discount stores have been operating for longer in the UK.

These findings show that both type of store and travel time are important in defining markets. While there is no comparable research for Australia, we would expect that these factors apply to Australian households in a similar fashion:

- The travel time factor is likely to be even more important in Australia, which covers a far greater geographical area but is more sparsely populated. In Australia, shopping patterns reveal that around 80% of shoppers live within 3 km of the store they most often visit.[20]
- Differences in store size are also a common method of categorising retailers in Australia. A full-line supermarket is generally in the order of 2,500-3000 sqm but in some cases

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[19] UKCC, Groceries Market Investigation Provisional Findings Report, 2007

[20] IBISWorld, Supermarkets and Other Grocery (except Convenience) Stores in Australia, 2008

can reach up to 5000 sqm. Coles or Woolworths supermarkets may be as small as 2500 sqm, while IGA and Foodworks generally have smaller models. Limited range discounters such as Aldi typically have a floor size of around 850 sqm and carry around 900 SKUs.

- Differences in store fascia are also common in Australia. Coles, Woolworths, IGA, Foodworks and Franklins generally advertise themselves as full range operators. Aldi is marketed as a limited-range discount store. Specialty retailers generally market themselves around their niche offering, as fruit and vegetable shops, fish shops, butchers and / or gourmet specialty stores.

These factors, which indicate that there are many different 'markets' for grocery shopping in Australia, must be considered when analysing the level of consumer choice available in grocery retailers.

Q31 Does the nature of competition in grocery retailing differ across products groups? Does the nature of competition differ across the types of shopping trips? What elements of the customer offer are important in each product group?

Q32 Who are the major competitors to the MSCs in each of the products groups?

The existence of specialised retailers that stock an extensive range of a particular product group, such as fruit and vegetable shops, butchers and fish shops, means that fresh food is available from a variety of outlets beyond the traditional supermarket. As disposable income rises, consumers are also able to eat out more often and visit restaurants, cafes as well as takeaway stores. The "home meal replacement" (HMR) product segment is also growing strongly. However, "share of stomach" measures of food purchases from different outlets are not appropriate definitions of the grocery retail market. The retail market should be defined by the space in which players compete against each other through the "value bundle" of their retail offer (including convenience, range, service, etc), and should not be defined by the simple presence of food products.

Supermarkets do not operate in the same market as other food retailers, as:

- fresh food accounts for less than half (45%) of the average monthly spend on groceries[21];
- despite the availability of fresh food from non-supermarket retailers such as fruit and vegetable shops, butchers and fish shops, supermarkets still account for 73% of fresh food sales[22];
- a 2007 ACNielsen survey of consumers showed that 89% of consumers "spend most money" in a supermarket compared

[21] ACNielsen, Shopper Trends 2008

[22] ACNielsen, Nielsen Homescan, 2008

to other types of retailers, and the proportion of consumers who do so has remained unchanged from 2006;[23]

- "asymmetric constraint", whereby specialty retailers are constrained by the supermarkets but not vice versa, is a reality that was confirmed in the UK and is likely to exist in Australia. Even where a "parade" of specialist retailers exist, the UKCC found that they were not seen by consumers as a close substitute for a supermarket; and

- supermarkets account for the vast majority of purchases for packaged groceries such as biscuits (99%), snacks (97%) and soft drinks (92%) for consumers that purchase these foods.[24] Overall, supermarkets account for 95% of packaged grocery sales.[25]

The consumer is faced with very limited choice when he or she wishes to purchase packaged groceries, which make up 55% of the average monthly spend on groceries in Australia.[26] The level of choice is further reduced when the consumer wishes to purchase branded, packaged groceries, a market which ALDI does not specifically target.

The large regular supermarket shopping trip (as opposed to 'top up' and 'convenience' purchases) is still very central to Australian households. The average number of shopping trips per week undertaken by Australian households has steadily decreased from 2.8 in 2000[27] to 1.7 in 2007.[28] This fact is confirmed by data from IGA banner retailers, shown in Section 3 of the confidential annexure to this submission. Consumers undertake larger shopping trips (the traditional 'weekly' shop) at larger, broad range retailers. Therefore, convenience stores and smaller retail outlets should not be considered to operate in the space in which rivalry and competition takes place between the larger, broad range supermarkets.

The UKCC's modelling of consumer demand based on the shopping behaviour of 11,382 households found that

- larger stores were constrained only by other larger stores within a 10-15 minute drive;

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23 ACNielsen, Shopper Trends 2008

24 ACNielsen, Shopper Trends 2008

25 ACNielsen, Nielsen Homescan, 2008

26 ACNielsen, Shopper Trends 2008

27 Based on ACNielsen, Nielsen Homescan data, 2000, as quoted in NECG's report Creeping Acquisitions in the Australian Grocery Industry, 2003

28 ACNielsen, Nielsen Homescan, 2008

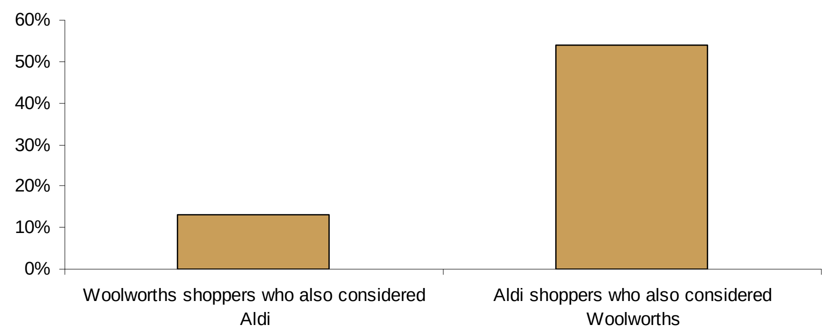
- mid-sized stores were constrained by other midsized stores within 5-10 minutes and other larger stores within 10-15 minutes; and

- convenience stores were constrained by other convenience stores within 5-10 minutes and other larger stores within 10-15 minutes.

The UK findings suggest that consumers highly value the convenience of purchasing from a retailer offering a broad range of grocery products, as smaller stores (which typically do not offer such a broad range) are not viewed as suitable substitutes to larger, broad range stores. The Canadian Government also looks to the size of stores, the range of SKUs stocked, and the geographic area in defining a relevant market.[29]

Asymmetric constraints mean that defining the market to include all grocery retailers would likely underestimate the market share of the MSCs. Metcash expects that the findings in the UK and Canada – that consumers only view other broad range, large supermarkets as a close substitute for a broad range, large supermarket – also apply in Australia. This is supported by Figure 8, which shows the results of a survey of customers on which other shops they considered on their last shopping trip.

**Figure 8 Asymmetric substitution**



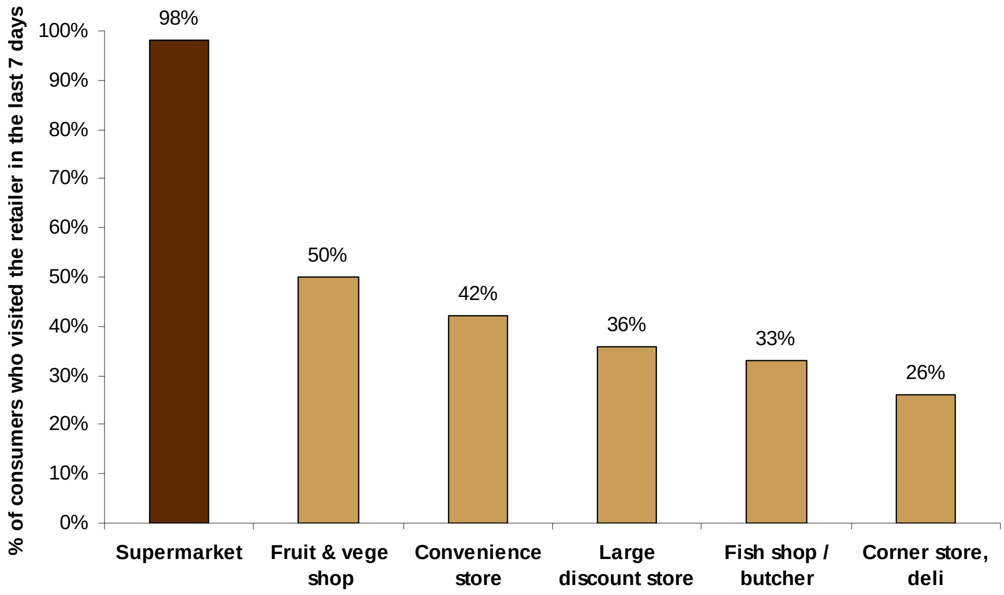

Source: ACNielsen, IGA Shopper Satisfaction – National Level Findings, 2008

In simple terms, the limited range discounter Aldi may compete with a Woolworths or Coles supermarket for a share of the consumer spend on groceries, but only a Supa IGA or Franklins store could be considered a major competitor to a large Woolworths or Coles store for the 'weekly' shopping trip.

[29] Canada Competition Bureau, Draft Enforcement Guidelines: The Abuse of Dominance Provisions (Sections 78 and 79 of the Competition Act) as Applied to the Retail Grocery Industry, 2001

Shopping habits of consumers in Australia provide evidence for asymmetric constraints: Figure 9 below show the results of an ACNielsen survey on the stores visited by respondents in a 7 day period.

**Figure 9: Type of stores visited by Australian consumers in a week**




Source: ACNielsen, Shopper Trends 2008

The above figure shows that Australian consumers are not substituting the traditional supermarket with other specialty stores. Almost all consumers surveyed (98%) visited a supermarket in the last week, compared to less than half who had visited some other specialty store.

The above chart also suggests that, in a week, approximately half of all consumers purchase fruit and vegetables from specialty shops and around a third purchase meat and seafood from specialty shops, but almost all made purchases from a supermarket.

In conclusion, there are numerous local markets (each encompassing a geographic area of approximately 10-15 minutes travel time) for the retail supply of a broad range of groceries (meeting the needs of the ‘weekly shopping trip’) to Australian consumers. The participants in these markets are limited to large supermarkets which offer a broad range of groceries, including Coles, Woolworths, Franklins and Supa IGAs. Specialty retailers (such as fruit and vegetable shops, butchers and bakers), limited range discounters (such as Aldi) and take away restaurants are not participants in these markets.[30]

## 5.2 Concentration in the Australian grocery retail market

Industry convention is to use the value of sales as the most appropriate way of measuring the shares of grocery retailers. The number of stores alone does not adequately reflect differences in store size between retailers. Areas of floor space could be useful as a measure of the potential capacity of retailer's stores, as there are limits to the amount of sales a store of a certain size can generate, beyond which the retailer's ability to keep adequate stock levels and queue sizes declines.

Metcash's view is that the market share for grocery retailing is best calculated on the basis of sales value, with the market defined as other retailers of at least a similar size and type within a certain catchment area. However, in the absence of comprehensive data for specific geographic areas, ACNielsen ScanTrack and HomeScan data is used to provide a preliminary estimate of the level of concentration in the industry.

ACNielsen ScanTrack data (which measures scan sales through all supermarkets and grocery stores and is complemented with warehouse withdrawals for independents) and HomeScan data (which is based on 10,000 demographically representative households across metro and regional Australia and records all in-home consumption of packaged and fresh grocery products in all outlets) is the standard adopted by many industry analysts in measuring the market share of retailers.

Details of data provided by ACNielsen can be found in the confidential annexure to this submission. Please see Figure 1 in the confidential annexure on the proportion of packaged groceries sold through each supermarket operator. The information shows that the grocery retail market is highly concentrated in Australia. This conclusion is in line with other analysis which estimate the market share of the MSCs is at least 74% to 80%.[31]

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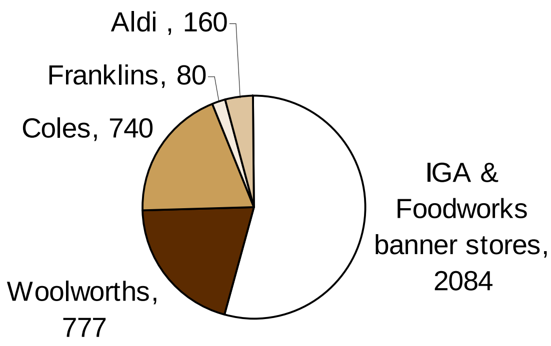
[30] In numerous recent merger decisions, the ACCC has defined local markets for the retail supply of groceries by supermarkets.

[31] 74% as estimated by IBISWorld in *Supermarkets and Other Grocery (except Convenience) Stores in Australia, 2008* and 80% as estimated by NARGA's report on *The economic contribution of small to medium-sized grocery retailers to the Australian economy, 2008.*

The following figure shows the approximate number of large, broad range supermarkets that are operated by each major player.

**Figure 10 The MSCs have a low number of stores but a very high share of sales**




Source: respective company websites

Independent retailers have a much larger number of stores but a much smaller share of the market, as a result of differences in store size and the fact that the MSCs are mostly located in metropolitan and larger regional centres. Many independent retailers operate in much smaller towns and have difficulty gaining access to suitable sites in the larger centres.

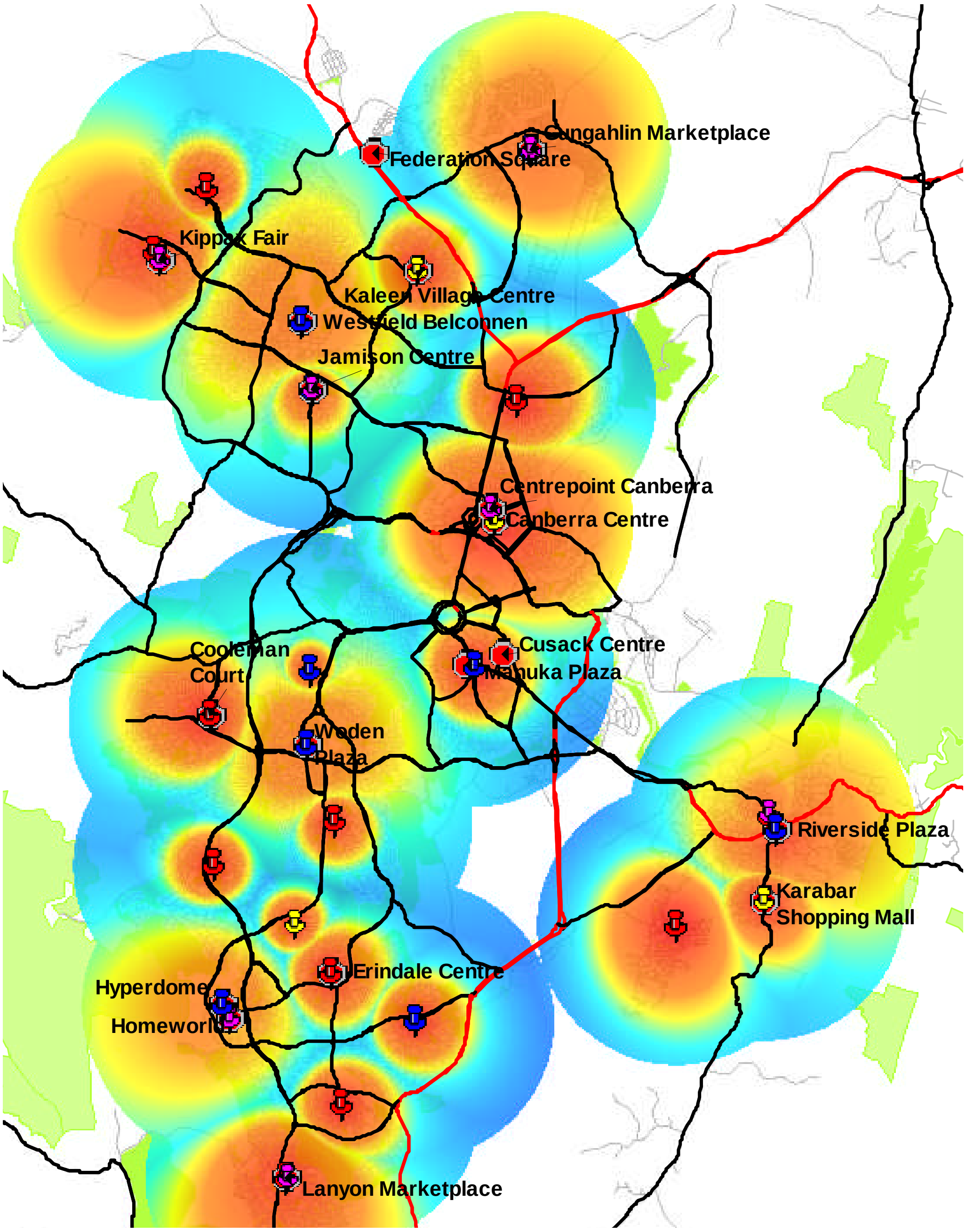
The comparison of store numbers against the retailers' shares of trade for packaged groceries further emphasises the fact that the majority of large shopping trips take place in larger stores. Most Foodworks and IGA banner stores tend to be smaller than the stores operated by Coles and Woolworths.

The market shares as calculated by Figure 1 in the confidential annexure understate the true level of concentration in the market, because:

- Local geographic markets would reveal higher concentrations in many areas. Please see Figure 2 in the confidential annexure for market shares calculated on a state basis.

  On a local level, there are many areas in Australia where consumers have little choice outside of the MSCs. The map below of the ACT (Figure 11) shows that for many catchments within ACT, the only broad range supermarkets are those operated by Coles or Woolworths.

**Figure 11 Supermarkets in Canberra**




Note: Blue markers represent Coles stores and red markers represent Woolworths stores. Purple and yellow markers represent Aldi and Supabarn respectively. The orange shaded areas are indicative of the size of sales achieved by each store.

- Sales from all IGA & Foodworks stores are included, although only the larger stores within these banners (such as a Supa IGA) are truly competing in the same market as traditional Woolworths and Coles stores as small stores are typically not considered a close substitute to larger stores; and
- Aldi store sales are included, although they should not be considered in defining the market since limited range discount

stores are not considered a close substitute to broad range retailers by consumers.

This conservative estimate of packaged groceries market shares for the MSCs still reveals that the Australian grocery retail market is highly concentrated:

- The Herfindahl-Hirschman Index (HHI), a widely adopted measure of market concentration, is substantially higher than over 2,000. The ACCC's draft merger guidelines published in 2008 state that a HHI of over 2,000 indicates a concentrated market.
- The four firm concentration ratio (CR4) is over 75%. The ACCC's merger guidelines published in 1999 states that a market is considered to be concentrated if CR4 is 75% or more.

The high level of concentration extends even into the market for fresh food. Figure 3 in the confidential annexure shows retailers' share of trade for fresh food, and indicates that Coles and Woolworths also dominate the market for fresh food. The MSCs' market share is very high for some categories of fresh food, as highlighted in Figure 4 in the confidential annexure. The information shows that non-supermarket retailers constitute a significant share of the retail trade for fresh bread / bakery products, but have a much smaller share in other categories.

When asymmetric constraints are taken into account (i.e. a deli is not a close substitute for a broad range supermarket), it is clear that the Australian grocery market is highly concentrated even in respect of fresh food.

Australia has the one of the most concentrated grocery retail markets in the world. The UKCC's 2000 report showed that, if only stores greater than 1400 sqm are taken into account, the market share of the top five MSCs for one-stop shopping in the UK was 89.3% with a HHI of 1,955.[32] These concentration figures are far below that of the Australian market, which has a HHI of at least 3,000 even before adjusting for store size differences.

[32] UKCC, Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom, 2000

## Australia is large enough to sustain at least three large retail chains

Q37 Is the Australian grocery industry of a sufficient size to sustain a third supermarket chain of similar size to Coles and Woolworths?

Some industry participants have suggested that the current level of concentration in the Australian grocery market is simply a reflection of its small population and low population density, implying that a highly concentrated retail market is the only efficient outcome possible. However, an examination of overseas evidence from similar countries shows that this is not a valid argument.

A case study of the Canadian grocery retailing sector is particularly instructive due to its numerous parallels and similarities to Australia:

- small population size – Australia has a population of approximately 20.3m; Canada has a population of 32.3m;[33]
- low population density – both countries have a population density of 3 people per sqm;[34] and
- Consumers are likely to be relatively similar in both countries due to common traditions stemming from membership of the British Commonwealth.

In 2001, the Canadian Competition Bureau commissioned a number of reports in relation to market power in the $60bn food retailing industry. The Bureau estimated that the four largest supermarket chains – Loblaws, Sobeys, Canada Safeway and Metro – accounted for approximately 75% of total Canadian food store sales.[35] The Canadian experience suggests that the Australian population should also be able to sustain at least three supermarket chains.

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[33] United Nations, World Population Prospects: The 2006 Revision

[34] Ibid

[35] Canada Competition Bureau, Enforcement Guidelines: The Abuse of Dominance Provisions (Sections 78 and 79 of the Competition Act) as Applied to the Retail Grocery Industry, 2001

## 5.3 Impediments to effective competition

### Lack of access to sites is the key impediment to large scale expansion of independent retailers

Q39 Is access to suitable sites a significant impediment to the entry or expansion of supermarket chains? Do local planning and zoning laws impede access to suitable sites? Please provide details.

Q40 Are major shopping centre landlords willing to offer sufficient space to a new supermarket chain? Are there any restrictions (contractual or otherwise) that may limit the ability of landlords to offer such space?

Keeping in mind that competition between supermarkets occurs at a local level, as consumers are not willing to travel much further than 10-15 minutes for groceries, a key constraint for the conduct of the MSCs would be the establishment of a large, independent grocery retailer (such as a Supa IGA) in a local market.

The key constraint to the large-scale entry of new retailers or the expansion of existing retail chains (such as Supa IGA) is a lack of adequate sites. The location of a grocery retail outlet has significant implications on its ability to attract critical masses of customers and gain market share.

Most Australians now undertake shopping activities in either shopping centres or business and retail activity centres, and a retailer must be able to secure sites in these locations to be attractive to customers. In many shopping centres the incumbent tenants are the MSCs who have secured long term leases (20-30 years).

In addition, the MSCs are undertaking strategic behaviour to further entrench their position. In the case of shopping centres, the following factors have resulted in the MSCs becoming further entrenched by denying new sites to other grocery retailers:

Q63 Is there evidence of any anti-competitive conduct in grocery retailing? What types of market conduct are of most concern to grocery retailers and wholesalers?

- Restrictive Covenants: The contracts that landlords have with the MSCs often contain restrictive covenants which forbid the landlord from leasing premises to other grocery retailers. The difficulty of circumventing such covenants was illustrated in Bunbury Western Australia, where a shopping centre operator actually had to build an adjacent centre, which was located just metres away from the existing centre, in order to lease a site to a new grocery retailer.

- Penalty Clauses: Contracts between landlords and the MSCs often contain clauses which allow the incumbent retailer to drastically reduce the rent it pays if the landlord leases to a new grocery retailer or allows a competitor to expand beyond a certain size. The new rent that is received is nearly always insufficient to cover the amount lost from the incumbent, meaning that it is not viable for the landlord to provide a lease to the new operator. For example, the lease between Woolworths and Tweed City Shopping Centre in Tweed Heads dictates a rental reduction of around $400,000 per year if a competing supermarket was allowed to expand beyond a certain size.

- Leverage: Landlords in shopping centres are often reluctant to deal with independent grocery retailers in fear of jeopardising their relationships with the MSCs. There are only a few operators of large shopping centres in Australia, and the MSCs are able to leverage their relationship with the landlords because the MSCs usually already have multiple presences in the landlord's sites.

These factors make it extremely difficult for a potential new entrant to establish a presence in retail activity centres. Consequently, they are often forced to pursue rezoning in 'out-of centre' developments. This is difficult because:

- Zoning laws favour existing retail activity centres: The process required to obtain approval for new developments, which should occur in areas zoned as retail activity centres, is difficult. Such land is in a geographically finite area within existing communities and is therefore in short supply. This means that those operators enjoying prime locations are often entrenched, with new entrants unable to obtain land with good retail characteristics or unable to obtain any land at all.

- Vendors are often unwilling to sell land to a buyer who is waiting on approval as it may take up to 18 months for the council to approve the development.

Grocery retailing is generally a mature industry and industry rules-of-thumb can be used to estimate the necessary amount of retail space needed to service a particular catchment area. However, the MSCs often move to pre-emptively acquire any available land before a new grocery retailer can enter the local market. The MSCs are better able to sustain long periods of depressed activity which result from the over-saturation of the market, as they have access to a large pool of resources. Such activity not only locks out competition, but also has an adverse impact on existing competitors.

One example of this is duplicate presences (for example, two Woolworths on either side of a road) which often result in over-saturation of the market (i.e. clearly unsustainable given the demographics of the local catchment). In some situations where an MSC's supermarket is reaching full utilisation in a shopping centre, another supermarket by the same MSC is opened at another part of the same shopping centre. However, such sites are usually not offered to independent retailers, resulting in a lost opportunity to improve competitive tension.

Examples of duplicate presences by Coles or Woolworths include Bondi Junction, Neutral Bay, Geelong, Robina, Wodonga, Bathurst and Chermside. The duplicate presence of the MSCs makes it unsustainable for another entrant to enter the local market, and hence reduces the level of competitive tension in the local market.

## Economies of scale are very important and must not be eroded for the 'third force' to compete against the MSCs

Q5 How important are economies of density, scale and scope in grocery retailing?

Q13 How important are economies of scale in grocery wholesaling? What are the sources of these economies of scale? Are economies of scale primarily the result of lower transport costs, lower storage costs, better stock management or the ability to negotiate better deals with suppliers?

An effective 'third force' in the grocery retailing market would need to achieve significant economies of scale, scope and density in order to compete effectively with the MSCs.

Over the past decade, Metcash has adopted a number of approaches in an attempt to achieve the same scale economies as the MSCs.  It is important that these economies are not eroded by further creeping acquisitions by the MSCs in the market.

A detailed discussion of the effects of economies of scale, scope and density on different cost inputs is provided below.

### Effect on per-unit cost of goods

Q72 What is the nature of the supply arrangements you have with suppliers? How are prices determined under these arrangements

Q46. Are large grocery wholesalers or retailers able to acquire products from suppliers at lower prices or on better terms than smaller wholesalers or retailers? Does this differ by product type?

The following figure outlines the way that the price of product purchases from suppliers is calculated.

**Figure 12: Pricing structure from suppliers**

| | |
|---|---|
| *Less* | Public terms |
| *Equals* | Net price |
| *Less* | Promotional/marketing terms |
| *Less* | Other discounts / allowances |
| *Equals* | Net net price |

The following table provides an explanation of these terms and the key drivers of each of the components.

**Table 5: Pricing structure from suppliers**

| Term | Explanation | Drivers |
|---|---|---|
| Supplier List Price | Published price for the product, before any terms or discounts.<br><br>Available to all customers of the supplier. | Supply and demand for the product |
| Public Terms (and cash discount) | Terms available to all buyers.<br><br>Available to all customer of the supplier that satisfies hurdle requirements. | Such terms are generally based on the volume of the order, and as the volume increases, the percentage of the benefits from these will increase.<br><br>The higher the volume of products ordered, the higher the discount.<br><br>Discount given for Full Truck Loads (FTL), Full Pallet Orders (FPO), compliance to payment terms, etc. |
| Net Price | The net price is based on the supplier list price less public terms. | As above – driven by volume discounts. |
| Promotional / marketing terms | Promotional / marketing income, generated through promotions that are jointly run by retailers. | The more stores that demonstrate compliance with the suppliers' promotional programs, the greater the value of promotional / marketing terms offered by the supplier.<br><br>Other drivers for the promotional terms suppliers provide a customer include:<br><br>• whether there is guaranteed ranging and grading of existing lines;<br>• whether there is guaranteed ranging and grading of new lines;<br>• the allocations of new lines to stores;<br>• whether there is national distribution of the supplier's product range;<br>• shelf positioning of the product range via an approved Shelf Layout Plan;<br>• existence of promotional programs;<br>• frequency of promotional programs;<br>• allocation of promotional lines;<br>• number of promotional display points; and<br>• type of advertising mediums used. |

| Term | Explanation | Drivers |
|---|---|---|
| Other discounts/ allowances | Other discounts, rebates and allowance can be obtained through one-off deals, advertising income and other rebates from suppliers. | The value of other discounts and allowances is dependent on the outcome of bargaining between buyers and suppliers. The bargaining position of a buyer will depend on:<br>• the annual volumes purchased from the supplier;<br>• the level of store compliance to promotional programs (i.e. consistency of volume); and<br>• the brand equity associated with retailer brands. |
| Net Net Price | The net net price is based on the net price less promotional/marketing income and deal specific discounts. | All of the above |

Q48 Do suppliers incur lower unit costs in supplying larger wholesalers or retailers? What are the sources of these costs savings (bulk sales, purchase guarantees, etc.)? Are these reflected at the retail level?

Q49 Do suppliers offer the same terms and conditions to all grocery wholesalers or retailers? For example, if a small wholesaler offered to purchase the same volume as a large wholesaler, would the small wholesaler receive the same volume discount?

It is evident from the table above that the volume of products required, and the assurance behind volume requirements (i.e. store compliance) is a key driver of the level of discounts, etc that can be obtained from suppliers, which ultimately has a large impact on the net net price of products.

Due to the confidential nature of many of the terms, empirical evidence of the impact of scale economies is difficult to find. However, anecdotal evidence suggests that the level of promotional terms and other discounts obtained by the MSCs is around 2% higher than obtained by Metcash.

### *Pricing to independent Retailers*

IGA>D's pricing strategy is described in section 2 of the confidential annexure to this submission.

Q56. Are the wholesale prices independent and small retailers pay affected by the wholesale prices the MSCs pay? For instance, if a MSC puts pressure on a supplier to lower its prices will the supplier:

- attempt to 'make this up' by charging more to other wholesalers and retailers, or

- reduce the prices it charges other wholesalers and retailers so other wholesalers and retailers can remain competitive with the MSCs?

The major players in the Australian grocery market (such as Coles, Woolworths, Metcash/IGA and Foodworks), will negotiate and 'fight' for the promotional discounts and other allowances available from suppliers. As stated earlier in this section, the promotional terms and other allowances (the investment) offered by suppliers to the various player in the Australian grocery market is primarily driven by volume and the ability of retailers to execute promotions at the retail level.

Metcash does not have information on the impact of any terms negotiated by the MSCs on the prices Metcash (and hence independent retailers) pay.

## Freight

The cost of transporting goods between grocery wholesalers and retailers is calculated by truck loads. Economies of scale are maximised if products are transported in full truckloads. Use of a truck for less than a truckload will increase the per-unit transport cost. Therefore, achieving economies of scale by ensuring volumes sold by both grocery retailers and wholesalers are in full truck loads will reduce the per unit costs of groceries.

Where a retailer is able to have a dense network of stores within a geographic area, economies of density also apply as there are more opportunities for the pooling of orders to make a full truckload for delivery from the warehouse to retailers.

## Per unit cost of doing business

There are costs incurred by grocery wholesalers and retailers that are largely fixed costs, such as rent, utilities and labour. These overhead costs associated with per unit of product sold decline as product volumes increase, resulting in significant economies of scale.

Further, in relation to wholesaling activities, costs are also incurred through the order fulfilment process. Costs associated with invoicing and processing payment is approximately the same for large volume orders and small volume orders. Similarly, the per unit cost of picking small volume orders in the warehouse are higher than the per unit cost of picking larger volume orders for the same products.

## Promotional expenditure

There are economies of scale related to promotional expenditure as some costs (such as signage and advertising) are largely fixed. Therefore, where signage and advertising can generate large sales volumes, the promotional cost per unit of product sold can be minimised.

Economies of density also apply if there is a network of same branded retailers within a geographic region. Advertisements and promotions can be region specific, and therefore where there are a large number of grocery retailers in the same geographic region, the cost or advertising and promotion per store can be reduced.

## Cross selling opportunities

Economies of scope apply here as the strategic market placement of product categories such as bread, milk, bananas and soft drinks play an important role in attracting customers into the grocery retail outlet. This then provides the opportunity for the grocery retailer to cross-sell other higher margin items to the customer.

Q42 What has been the effect of acquisitions, particularly combinations of acquisitions, on the competitiveness of independent wholesalers and retailers?

Q62 In particular, have the relative costs of independent wholesalers been affected by recent merger activity in supermarkets? If possible, please provide evidence. Have prices paid by independent wholesalers and retailers to suppliers or terms of trade with suppliers been adversely affected? If possible, please provide evidence. Have there been flow-on effects to independent grocery retailers?

These economies of scope are also demonstrated by the introduction of non-grocery product lines (such as clothing) in supermarkets. These items tend to attract a higher gross margin on average. These products can be introduced to a grocery retail outlet at limited additional cost, as the staff and floorspace required is already available for the maintenance of grocery product lines.

The importance of economies of scale are highlighted in a 2003 report, which estimated that a 10 per cent reduction in sales volume (due to creeping acquisitions) would result in a 17 per cent decline in profit for Metcash as a wholesaler, or a 2.4 per cent increase in retailers' costs.[36]

In summary, economies of scale, scope and density are vital to maintaining a low cost of supply and hence the ability to pass on lower prices to retailers. Consequently, creeping acquisitions are extremely detrimental to the maintenance of competitive forces in the retail market - when an MSC acquires an independent retailer in an area, not only is there a reduction in the level of choice available to consumers in the area, but the entire cost base of the independent sector is also undermined due to the corresponding loss in economies of scale, scope and density.

[36] NECG, Creeping Acquisitions in the Australian Grocery Industry, 2003

## Vertical integration is not a pre-requisite for effectively competing against the MSCs

Q42 Are there commercial advantages and disadvantages of vertical integration between grocery retailing and wholesaling? What are these advantages and disadvantages?

Q43 Does the vertically-integration of the MSCs impede other players from achieving a competitive scale in grocery wholesaling?

Q77 Has the degree of vertical integration in the supply chain had an effect on the pricing of inputs? If so, in what way?

The MSCs operate in a vertically integrated manner where the wholesaler and retailer are part of a single organisation. The primary advantage of this structure manifests in the wholesaling functions of the entity, as a vertically integrated entity is able to achieve greater compliance (consistency of sales volumes for suppliers), through their control of:

- Shelf space: Suppliers can be assured of new product introductions and replacement products in all stores.
- Promotions: Promotions are introduced efficiently and consistently in a large network of stores in a vertically integrated grocery retailer model.
- Transport: The transport of products from suppliers to retailers is controlled and therefore transport contracts can be pooled and freight can be optimised through planning.

The key disadvantage of vertical integration manifests in the retailing function of the entity, as inflexibility within the product range at individual stores. As profit margins from the wholesaling function are derived mainly from economies of scale, there is an inherent inability for individual grocery retail outlets to tailor product ranges to the tastes of the community. This is because the unique product ranges may not necessarily be suitable for all other grocery retail outlets and therefore economies of scale in purchasing.

In comparison to the vertically integrated model adopted by the MSCs, the key advantage of the model operated by Metcash is the ability of grocery retailers to act independently. In comparison with the vertically integrated structures, there are fewer restrictions regarding the operation of the grocery retail outlet. This is highly valued by independent grocery retail operators as it enables them to respond quickly to changing consumer demands in their local community. The independence of the retailers enables product ranges and other aspects of the retail offer to be tailored to their local community.

In addition, Metcash has also been able to achieve cost savings for its customers through replicating some of the advantages of vertical integration while still maintaining the ‘independent’ nature of the retailers, including retail system support for point of sale and back office computer systems and a range of specialist service personnel including channel, business and fresh food managers. These services adopt a “whole of system” perspective and efficiencies can be gained across the wholesaling and retailing functions of the supply chain.

The key disadvantages of the Metcash / independent retailer model include:

- Lack of compliance compared to the vertically integrated model (i.e. Metcash cannot guarantee promotional compliance across their independent network), and hence suppliers are not as likely to invest in promotional support for independent retailers compared to the MSCs.
- Difficulties in streamlining business processes, which make it difficult for retailers to achieve in-store efficiencies at the level of MSCs.
- Difficulties in achieving economies of scale in non-trade procurement.
- Difficulty in joint investments which involve both the wholesale and retail functions of the supply chain, e.g. systems support for automated replenishment.

However, these differences are not large enough to prevent an independent grocery retailer from effectively competing against a vertically integrated player in the market.

Q50 Do slotting fees (fees paid by manufacturers or producers to have their products placed on supermarket shelves) reflect the existence of market power? What is the extent of slotting fees? How do slotting fees affect the competitive dynamic between producers/suppliers and the level of barriers to entry for producers/suppliers? How does the ability of supermarkets to control shelf placement and in-store promotional offers affect the competitive dynamic?

Metcash as a non-vertically integrated wholesaler cannot guarantee the shelf placement of products by independent grocery retailers. Therefore, it does not charge slotting fees to suppliers. However, when Metcash negotiates the introduction of new products with a supplier, it may charge a listing fee and negotiate some form of support for this product – either through introductory promotions and/or other allowances – in the first 6 – 12 months after new product introduction. Adequate support is vital for the success and viability of new products, and as such the listing fee does not represent the existence of market power, but are instead a part of the normal negotiations and joint planning between grocery suppliers and wholesalers/retailers.

## Summary – independent grocery retailers can be a more significant presence in the market if they have adequate access to sites

Q38 What are the key inputs that must be assembled to open a new grocery outlet of a given size?

Q41 To what degree are smaller supermarket chains discouraged from expanding by higher costs relative to the MSCs. What are the sources of higher costs (e.g. higher costs of wholesale groceries, inability to take advantage of economies of scale or density, etc.)?

Q57 Please provide any estimates of the differences in wholesale costs faced by small and independent retailers relative to the MSCs?

The following table analyses the ease of entry for independent grocery retailers to establish a rival presence to a MSC in a local market.

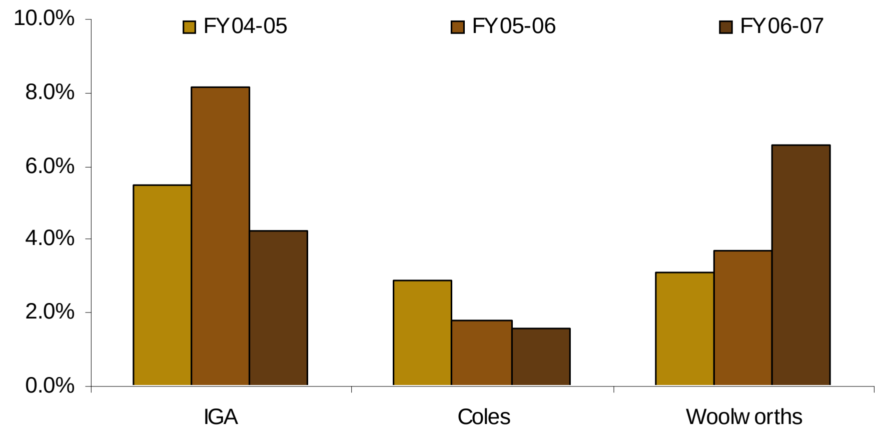
**Table 6: Constraints to expansion of independent grocery retailers**

| Required input into retail outlet | Availability | Cost differential between the MSCs and independent retailers |
|---|---|---|
| Land (suitably zoned) with adequate access to the catchment area | Low – lack of access to suitable sites | Minor differences |
| Building works | Readily available | Minor differences |
| Fit-out | Readily available | Minor differences |
| Staff | Low – but this also applies to the MSCs | No difference |
| Supply of products at a competitive cost | Readily available | Currently estimated at 2%, however differences will reduce if independent grocery retailers increase their market share. |

Q55 To what degree do differences in wholesale prices and other wholesale terms and conditions undermine or otherwise affect the competitive position of small and independent retailers?

Despite anecdotal evidence of a difference in the confidential marketing terms / other discounts obtained from suppliers between Metcash and the MSCs, independent retailers are proving competitive against the MSCs, as evidenced by their high comparable store annual revenue growth rates shown in Figure 13 below. Comparable store sales are an important industry measure as they exclude the impact of new store openings on total revenue.

**Figure 13 Comparable store annual revenue growth**




**Source: PricewaterhouseCoopers, analysis of IGA network, 2007**

The above figure shows that the comparable store annual growth figures for stores in the IGA network compares favourably to that of the MSCs, indicating that where they have a presence, independent retailers in the IGA network have been successful in competing against the MSCs.

## 5.4 Competition in the wholesale market

Q14 What are the most appropriate ways of measuring the shares of grocery wholesalers? Should industry or market shares be measured across all grocery items or for particular product categories (such as packaged food items, bakery, meat, fruit and vegetables, delicatessen products, etc)? If possible please provide quantitative estimates of shares of grocery wholesaling detailing the data sources and any assumptions made in estimating the shares. How have these shares changed over the past 5 to 10 years?

In defining the wholesale grocery market, the same approach as that outlined previously in relation to market definition for retail groceries should be adopted, i.e. according to the procedure outlined in the ACCC's Merger Guidelines.[37] In addition, delineation of the relevant functional market requires identification of the vertical stages of production and/or distribution. This involves consideration of:[38]

- Vertical integration;
- Commercial reality; and
- Substitution possibilities at adjacent vertical stages (i.e. indirect substitution)

In previous decisions regarding whether to consider the wholesale and retail operations together in estimating the wholesale market, the ACCC considered that there was a functional distinction between wholesaling and retailing, and that substitutability between the MSCs

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[37] See ACCC Merger Guideline 1999 and ACCC Draft Merger Guidelines 2008

[38] ACCC Merger 1999 Guide5.64

and the non-vertically integrated wholesalers was not sufficiently clear for independent retailers.[39]

Q9. How profitable are grocery retailers? What margins over wholesale costs do grocery retailers achieve? Do margins and profitability differ by the size and location of the store? If so, how? What rate of return on capital do grocery retailers achieve? Has this changed over the past 5 to 10 years?

However, this line of reasoning has been heavily criticised[40] and many consider that vertically integrated entities should also be included in the market definition. What is really occurring is an indirect substitution at the wholesale level.[41] If an independent wholesaler put up prices at the wholesale level, this would increase the cost of goods for retailers. Retailers would either have to absorb the cost increases (not possible given low margins in the retail industry – please see section 3 of the confidential annexure to this submission), or increase the prices of their goods.

This would cause a significant number of consumers to switch to the MSCs, with this substitution flowing back through the supply chain in the form of less volume of goods moving through the independent wholesaling sector compared to the MSCs. Therefore, vertically integrated wholesalers such as Coles and Woolworths should be included in the same market as Metcash.

The Trade Practices Tribunal took a different view to the ACCC just a few years later. In *Re QIW Ltd*[42], the tribunal delineated a submarket, but not a market, for the wholesale supply of independent retailers, and it held that prices in that submarket were 'subject to competitive discipline from the market as a whole',[43] in which the chains were also competitors. The Tribunal held that the merger of the only two competitors in the submarket of supply to independent retailers 'would have no anti-competitive impact' because of the competitive discipline from the MSCs.

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[39] QIW Retailers Limited v Davids Holdings Pty Ltd

[40] See, for example, Norman and P.L. Williams, "The Analysis of Market and Competition under the Trade Practices Act: Towards the Resolution of some hitherto Unresolved Issues" (1983) 11 ABLR 396

[41] See, for example, David Brewster (1996) "Market definition and substitutability : Australian courts continue to struggle with Part IV of the Trade Practices Act 1974 (Cth)" 12 Queensland University of Technology Law Journal 246, Gregory Werden and Diedre Hay (2005) "Bringing Australian merger control into the twenty-first century by incorporating unilateral effects" 13 Competition and Consumer Law Journal 119; Rhonda Smith and Jill Walker, "Australian Trade Practices and the Emerging Role of "Commercial Reality" versus Substitution in Market Definition", Rhonda Smith and Neville Norman, "Function market definition"

[42] (1995) 132 ALR 225.

[43] Ibid.

Q16. How profitable are grocery wholesalers? What margins over supply costs do grocery wholesalers achieve? Do these margins differ by size of the wholesaler? If so, how? What rate of return on capital do grocery wholesalers achieve? Has this changed over the past 5 to 10 years?

As a whole, Metcash and the retailers it serves achieve comparable profit margins to that achieved by the vertically integrated MSCs. The activities of Metcash as a wholesaler are heavily constrained by its need to maintain the viability of independent retailers. If independent grocery retailers are not achieving a competitive cost of supplies, their viability would be threatened and hence the revenue stream for Metcash as a wholesaler would also be threatened. .

Further, even if the independent wholesale grocery supplies were considered to operate in a separate market to the wholesale activities of the MSCs, the fact that Metcash is a large operator in this sector must be distinguished from the conclusion that it has market power. As set out above and below, Metcash's activities are constrained by a number of factors, most importantly by the need of its customers to compete with the MSCs at the retail level.

## 5.5 Constraints on activities of wholesalers

Beyond the need to maintain viability of the independent retailers, other factors that act as constraints on Metcash in the wholesale grocery market are examined in more detail below.

### Direct supply agreements

Q78 What impact, if any, does the presence of direct supply agreements have on the level of competition in the markets for those individual products?

For Metcash's customers, direct supply agreements are more prevalent in the fresh food product category relative to packaged goods.

The price paid for products in direct supply agreements are based on volume and consistency of ordering patterns. Independent grocery retailers therefore have significantly less buying power compared with the MSCs who purchase products at the farmgate in large volumes. As such, the bargaining power of the independent grocery retailer at the farmgate is considerably less than that enjoyed by the MSCs, and independent grocery retailers are at risk of being charged high prices by suppliers to enable those suppliers to achieve better margins.

Through the establishment of their Fresh distribution division in November 2007, Metcash is reducing this impact by aggregating the volumes of the independent grocery retailers to enhance their relative bargaining power. These reduced costs are then passed on by Metcash to its customers so that independent grocery retailers may be more competitive in the fresh food product category.

## Ability for retailers to 'bypass' the wholesalers

Q44 Can grocery retailers 'bypass' the large grocery wholesalers? If so, how? Does this vary by the type of product or type of retailer?

Metcash is constrained in its ability to exercise market power against the retailers as it is possible for retailers (such as a group of large independent stores) to form a purchasing collective and bypass Metcash.

There are several channels through which independent grocery retailers can bypass the wholesaler.

- Direct purchase from the farmgate;
- Direct purchase from markets; and
- Direct purchase from manufacturers.

## Threat of new entrants

Q45 What are the impediments to entry into grocery wholesaling? Is large-scale entry likely?

There is a credible threat that existing Metcash customers could, as a group, choose to establish their own wholesaling entity. This has occurred previously in the case of Franklins, which chose to undertake its own wholesaling activities instead of purchasing from Metcash.

In addition there is nothing to prevent a new player from entering the market. There are no licensing or other governmental regulatory restrictions that prevent firms from entering the industry. In addition, there are no resource constraints significant enough to prevent firms from entering the industry.[44] If a new entrant is able to obtain a supply contract for a large enough volume of goods for a reasonably long period of time, set up costs for warehouse and distribution facilities can be largely eliminated through long term leases from specialist logistics companies.

[44] IBISWorld, Grocery Wholesaling n.e.c in Australia, 2008

# 6 Importance of the independent retailer

As the 'third force' in a market dominated by two large players, independent retailers:

- keep retail prices competitive for customers through heavy promotional activity and maintaining local competitive tension against the MSCs;
- help prevent the abuse of market power by Woolworths and Coles in a 'cosy duopoly' which would be damaging to customers;
- help prevent the abuse of market power by Woolworths and Coles through practices such as delisting products which would damage suppliers; and
- reduce the risk that Woolworths and Coles would dominate the entire supply chain further by increasing their private label sales.

## 6.1 Keeping retail prices competitive

Q29 How do retailers compare their prices with those of other retailers? How often are such comparisons made? Over which products are such price comparisons made? Against which retailers do they compare prices? Are price comparisons done on a national or local basis, or both?

Q35 What are the grocery pricing policies of the MSCs, and other grocery retailers that operate in more than one location? Do individual supermarket chains set the same product prices across all their stores? If not, are individual product prices determined regionally or store-by-store? How much, if any, pricing discretion is in the hands of the management of individual stores? To what extent, if any, do major national retailers respond at the store or local levels to changes in the grocery prices of local competitors?

Q47 Do grocery wholesalers or retailers with buying power pass on the lower prices they can achieve from suppliers to retailers and consumers?

Q71 Do cost savings in the supply chain flow through to lower retail prices for consumers?

As a significant 'third force' competitor in a highly concentrated market that is dominated by two major players, independent retailers are vital in maintaining competitive pressure to keep prices low for customers.

While Metcash is not normally a retailer, it provides pricing advice to its retailers through undertaking price checks and assisting retailers to choose a pricing strategy appropriate for their store. Metcash's pricing advice is a guide only and independent retailers are largely free to set their own prices.

The retail pricing strategies typically followed by Australian retailers are characterised by:

- "follow the leader" pricing, where retailers monitor each other's shelf prices very closely, and price changes by one retailer for a particular product are usually matched within a short timeframe by other retailers in the same area; and
- Hi-Lo strategies, where temporary price reductions are heavily used to drive customer demand and volume, rather than EDLP strategies. This has the effect of both driving price competition as well as stimulating consumer demand.

The "price leadership" aspect of retail pricing has been criticised by some as a form of tacit collusion. However, with enough competitive tension at the local level, price leadership does not mean the prices set by retailers will not be at a competitive level. Competitive tension at the local retail level is compels retailers to pass on to consumers any cost savings the retailer has been able to achieve.

An analysis of local price data conducted in 2003 showed that whilst the MSCs exhibited limited price variations across local retail markets, lower prices in the MSCs' stores were significantly linked to the presence of local competition. Regression analysis of prices against competition suggested that the presence of independent supermarkets result in lower prices in the MSCs' stores in the same area. This is evidence that despite the advantages of uniform pricing, the level of local competition will benefit consumers in the form of lower prices.[45]

A number of similar studies in Canada, which has comparative population characteristics to Australia, have also found significant correlations between the level of concentration in the retail market and the price of grocery products.[46]

Q8 Are there any structural differences in grocery retailing in metropolitan, regional and country areas? If so, please explain.

Q36. To what degree do grocery prices differ between metropolitan, regional and country areas? How does this differ by product group? What are the major reasons for differences in grocery prices between metropolitan, regional and country areas (transport costs, land costs, market structure and competition, etc.)?

The level of local competition is the key driver of price differences, regardless of where the retailer is located. Around 53% of Metcash's customers operate in regional and country areas and the other 47% operate in metropolitan areas. Generally speaking, the key differences in supply chain costs (transport and land costs) between metropolitan and regional areas tend to have an offsetting effect against each other.

Local retail markets operate in catchment areas, which sometimes overlap. Overlapping catchment areas between competing retailers result in more competitive tension in those areas. A "chain of substitution" can form whereby successive overlapping catchment areas between competing retailers result in a "ripple effect". This means that although there are only approximately 416 Supa IGAs across Australia, their impact on maintaining competitive tension in the market extends beyond their own catchment areas.

The fact that the only significant constraints to broad range supermarkets are other broad range supermarkets makes the independent supermarket retailer a very significant player. In those markets in which they have a presence, independent retailers (such

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45 NECG, Creeping Acquisitions in the Australian Grocery Industry, 2003

46 Wen, J., Market Power in Grocery Retailing:Assessing the Evidence for Canada, Report prepared for the Competition Bureau, 2001

as a Supa IGA) contribute significantly to maintaining competitive tension through their:

Q54 What are the major sources of competitive advantage and disadvantage of small and independent retailers (e.g. trading hours, scale of operations, density of retail outlets, location of retail outlets, wholesale prices, product and brand range, customer service, etc.)?

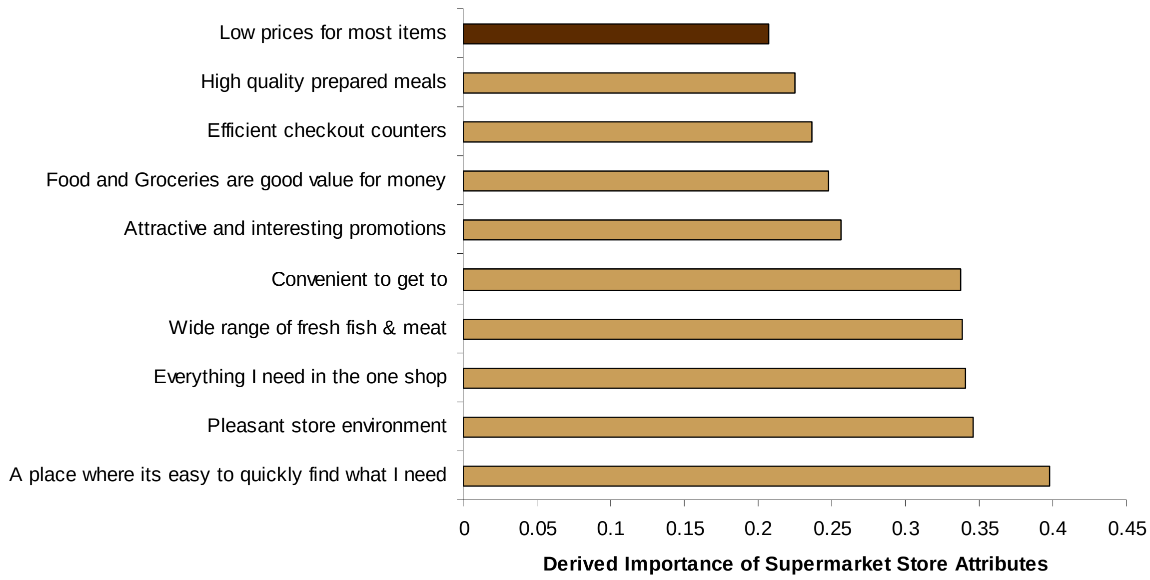
- Intensive promotional pricing. Independent retailers who source groceries from Metcash have around 2,000 – 3,000 items on temporary price reductions (TPRs) on any one day, which amounts to around 40% of grocery product sales by volume. Metcash's experience has shown that Australian consumers have a high propensity to switch brands depending on which products are on temporary price reductions at the time of purchase.
- Competitive shelf prices. Metcash's pricing guides for retailers take into account the prices set by the MSCs in the same region; and
- Competitive advantage in their retail offer. Independent retailers also compete effectively against the MSCs through:
  - an emphasis on personal service;
  - niche ranging to cater to local demand characteristics;
  - community links and community giveback;
  - speed / flexibility offered to customers through its difference from the 'big box' format of the MSCs' stores; and
  - locational convenience.

An ACNielsen study on performance attributes of IGA against Woolworths, Coles and Aldi found that IGA outperformed competitors in its "service" and "community" attributes, and was also competitive in terms of location and convenience.

Q25 How important is price for consumers when they decide where to buy groceries? Does this differ depending on the grocery product?

Australian consumers are relatively price conscious compared to overseas markets. However, Figure 14 below shows that the average consumer values the convenience, service and range offered by supermarkets much more than price considerations. Therefore, independent retailers can also maintain significant competitive pressure on the MSCs through the non-price aspects of their retail offer.

**Figure 14: The 5 most important and 5 least important store attributes**




Source: ACNielsen, Shopper Trends 2008

The above chart also highlights the fact that consumers highly value the broad range product offering of supermarkets (i.e. narrow range specialty stores and convenience stores are not in the same market as supermarkets), and the importance of obtaining access to an appropriate site in establishing retail operations.

In a survey of customers who shopped at Woolworths or Coles on their last shopping trip, 17-21% considered shopping in an IGA store, demonstrating that the independent sector is still competitive against the MSCs. This figure is likely to be much higher for larger independent stores such as Supa IGAs.

Q53 How could grocery wholesalers or retailers exercise any market power? Could major retailers credibly threaten to 'delist' a product or brand? How would consumers react if their desired brands are not available at their local supermarket? How important is the potential for a grocery retailer to substitute to a private-label or generic brand? Do major retailers threaten to import products in preference to local brands and how credible is the threat? What options do suppliers have if this occurs? Where else could suppliers sell their products (other grocery retailers, exports)? What are the consequences at the retail level?

Q75 What are the consequences for suppliers of any market power of grocery wholesalers or retailers in the acquisition of grocery products (e.g. lower prices to suppliers, transfer of risk and/or costs to suppliers, decreased incentive for investment and innovation along the grocery supply chain, etc.)?

Q76 What are the potential consequences of suppliers having any market power along the grocery supply chain?

## 6.2 Maintaining a competitive supplier market

There is some evidence to suggest that the market for suppliers is relatively concentrated. The 20 largest food and soft drink manufacturers in Australia account for almost 50% of total industry turnover. In some product categories, the largest two suppliers own or share over 50% of the market.[47]

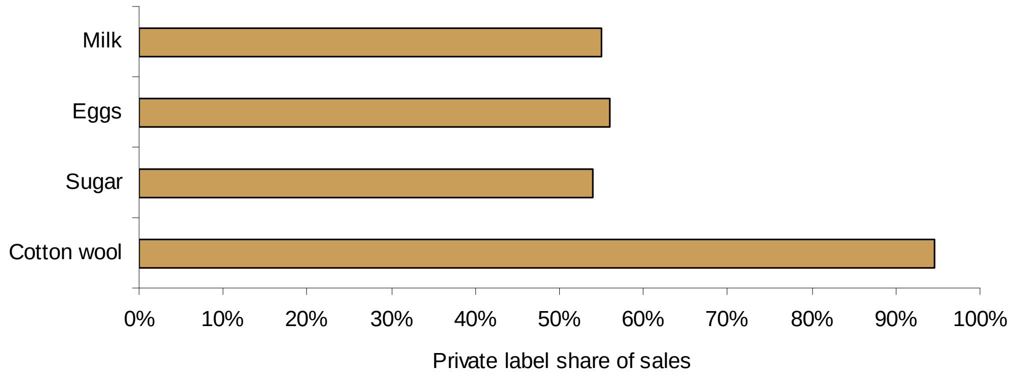
The MSCs can credibly threaten the delisting of products and/or ranges of suppliers either as a ranging strategy or to favour their private label brands. In a highly concentrated market, the delisting of products by the MSCs could result in suppliers exiting the market, thus further intensifying the level of market concentration. However, the effect of the delisting of a supplier by an MSC may be reduced if independent grocery retailers have a significant presence, as they would be able to continue supplying the product to consumers.

## 6.3 Reducing the risk of the MSCs dominating the market through their own private label products

In 2006, private label was the number one area of concern for grocery suppliers. This is because private label has the potential to damage those branded products which rank third and fourth in their product categories. The best selling private label products are presented below.

[47] Department of Foreign Affairs and Trade, 2008

**Figure 15: Private label share of sales, 2007**




Source: IBISWorld, 2007

The above chart shows that for some products, private labels already dominate the market.

Suppliers are competing intensely with grocery retailers for valuable shelf space to sell their products, as grocery retailers reap the benefits of their private label brands. Overseas experience demonstrates that this concern is very real, as some 40% of the shelf space of Walmart in the US is occupied by private label products[48].

Like Tesco in the UK, both Coles and Woolworths have launched premium private label ranges in an attempt to segment the private label market.

Metcash has targets to increase its private label sales to 12-15% of total sales. This is a modest target, as Metcash believes that one of the competitive advantages of independent retailers is their ability to stock proprietary brand products.

Any retailer that holds extensive market power can have detrimental consequences on all other players along the grocery supply chain. The risk is that if the MSCs continue to increase their market share (through mergers and acquisitions, etc) and continue to focus on private label products, the MSCs would effectively control the entire supply chain. The potential consequences of this are summarised in the table below.

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[48] FoodWeek, Surviving the Supermarket Shelf Squeeze, 28 November 2007

**Table 7: Potential impact of the MSCs' market power as private label owners**

| Impact | Explanation |
|---|---|
| Increase in grocery retail prices | The decline of other brands may allow the MSCs to command excessive premiums upon sale of their private label products, which will cause grocery prices to increase. |
| Reduction of product range | The MSCs could exercise their market power to impose restrictions on the products that may compete with their own at the retail level. This will greatly reduce product ranges available to end consumers. |
| Reduction in supplies available for other retailers | The decline of other brands would eventually reduce the number of suppliers in the market, this will reduce the amount of supplies available for other retailers and hence further reduce competitive tension in the supply chain. |
| Reduction in profitability of primary producers | In the case where the MSC has strong market power as a private label owner, primary producers may be forced to sell their products at low margins. This may render their business unsustainable and therefore reduce the overall supply of their product. This will have further effects of increasing grocery prices. |
| Reduction in service/availability of products | Where one brand dominates a product category, there may be less incentive for suppliers to maintain sufficient levels of product to be sold to their customers. This may have the effect of increasing prices of the product due to its insufficient supply to the market. |

The impact of the growing private label focus by the MSCs is potentially devastating for Australian suppliers as Australia is in the unique position of having the one of the most highly concentrated retail markets in the world. A strong independent retailer presence is vital to maintaining the viability of Australian suppliers and brands valued by consumers.

## 6.4 Preventing the abuse of market power by the MSCs

Q52 Are there other forms of behaviour or conduct by supermarkets in their dealings with producers or suppliers that may indicate market power?

Coordinated conduct and abuse of market power is a real concern for Australia, where many local markets are dominated by a duopoly of Coles and Woolworths supermarkets. Examples where the MSCs have engaged in such conduct include:

- in 2006 Woolworths was found to have contravened s 45 of the TPA due to the fact that deeds in Campbelltown and Tweed Heads contained exclusionary provisions and deeds in Campbelltown, Rockdale/Arncliffe and Tweed Heads contained provisions which had the effect of substantially lessening competition.[49]

- In 2004, Woolworths was also found to have contravened the price-fixing provisions of the TPA by entering into and giving effect to a contract, arrangement or understanding with Rhonwood Pty Ltd and the Arnhem Club that it would not sell certain products at a discount in its Nhulunbuy retail stores.[50]

- In 2003, Woolworth's Victorian branch, Safeway, was found to have contravened s 46 of the TPA. Safeway was found to have taken advantage of its market power in the market in Victoria for the supply, on a wholesale basis, of bread to food retailers by ceasing to acquire, display and sell bread products of Buttercup Bakeries in their supermarkets in Frankston, Cheltenham and Vermont and Tip Top bakeries in their supermarkets at Albury, Lavington and Wodonga for the purpose of deterring those manufacturers from selling their products in other stores at a discounted price. Safeway also contravened s45(2)(a)(ii) through its arrangement or understanding with Tip Top that Tip Top would sell loaves at its Preston stall at a certain price.[51]

Economic theory shows that anti-competitive conduct is more likely if there are less players in the market. Independent retailers serve an important purpose in this regard as they are generally free to choose their own prices, thus increasing the number of firms in the market that set prices independently.

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[49] See Australian Competition and Consumer Commission v Liquorland Australia Pty Ltd [2006] FCA 826

[50] See Australian Competition and Consumer Commission v Woolworths (South Australia) Pty Ltd (No 2) [2004] FCA 128

[51] See Australian Competition and Consumer Commission v Australian Safeway Stores Pty Ltd (no 2) [2003] FCAFC 163

Without independent retailers, the market is left with only two major players (Coles and Woolworths), a ‘cosy duopoly’ that will not deliver the benefits of robust competition to consumers.

## 6.5 Importance to suppliers

Q50 Is there evidence that large grocery wholesalers have market power as acquirers of products and what are its effects at the retail level?

Market power is already exercised by the MSCs – suppliers have suggested privately that the forcing of primary freight onto suppliers and threats of de-listing are key areas of concern to them. However, suppliers are extremely dependent on the MSCs in distributing their products and hence do not raise these issues publicly.

The following quotes from interviews with suppliers to Metcash, ranging from multinational companies to large Australian manufacturers, also highlight the importance of the independent retail sector.

- "We would like to see an active, progressive Metcash as a viable 3rd player in the Australian grocery market" – a multinational manufacturer of personal care products.
- "It is difficult to trade in the Australian market which is probably the most concentrated grocery retail market in the world" – another large manufacturer of personal care products.
- “Having a strong 3rd force in the market is a good thing" and “we would like to see an even stronger Metcash / Independent network” " – a large packaged food manufacturer.

# 7 Communicating price information to customers

Australian retailers heavily advertise promotions through catalogues as well as mass media. However, it is difficult to compare prices between stores due to differences in the retail offer, the complexity in defining a representative basket and the constantly changing nature of prices.

Unit pricing is costly to implement and its benefits should be carefully weighed against its costs. Unit price tags tend to entice consumers to switch to buying larger sizes, which may not always result in a net benefit to the consumer.

## 7.1 Comparing prices between retailers

Q27 How do consumers gain information on the pricing of grocery retailers (advertising by grocery retailers, word of mouth, comparisons of key grocery items, etc.)?

Q28 What strategies do grocery retailers use to signal their price offers to consumers? What strategies do retailers consider to be the most effective? How do retailers assess the effectiveness of their strategies?

In 2007, grocery retailers spent a total of around $153 million on advertising through press ($72m), television ($67m), radio ($6m), magazines ($6m) and direct mail.[52]

On top of this spending, a large amount was also spent on catalogues outlining promotional deals. In a recent survey of Australian supermarket shoppers, over 71% recalled receiving Woolworths / Safeway catalogues and over half (51%) recalled receiving IGA catalogues.[53] This level of activity in advertising and catalogues indicate that Australian consumers already have access to a large amount of price information

Failure of consumers to engage in price search would mean that even with a competitive structure, the retail market would not operate competitively. However, consumers always have incomplete information regarding prices at any time due to a range of factors, including the following:

- Prices are constantly adjusted, with many items on promotion at any time.
- Retailers compete not only on price, but also on a multitude of other factors that make up the retail offer, including store location, attractiveness of displays, etc.
- Retailers price each item as part of a strategic whole, for example “key value items” such as milk and soft drinks may be

[52] Starcom, National Supermarket Media Competitive Review, 2008

[53] ACNielsen, IGA Shopper Satisfaction, 2008

priced at a lower margin in order to attract customers into the store.

- Stores can charge different prices for the same products, without one store systematically charging higher prices than another.

- There are a significant quantity of non-overlapping brands and products between similar stores, and even more between different store formats. A study commissioned by the Canadian Competition Bureau stated that "regardless of how a grocery food price index is constructed, coverage will be incomplete."[54]

For these reasons, Australian retailers have attempted to create consumer perceptions about the value for money offered in their stores as part of their brand equity. However, in an environment where consumers have access to comparative price information from competing retailers through advertising, competition in the market will ensure that perceived and actual pricing strategies will remain relatively close. One of the reasons why Coles supermarkets lost market share in the late 1980s may have been Coles' poor pricing position despite their advertised claim of lower prices.

Metcash is not opposed to increasing the level of formal price monitoring in the market, but suggests that a more detailed evaluation of how a price monitoring system would work in practice is required. Metcash's analysis of the potential price monitoring system indicates that:

- the likely level of its usefulness in saving money for consumers is limited, due to the same reasons outlined above as to why consumers have incomplete information regarding prices. There is no compelling reason why a government implemented system of price monitoring would be able to overcome the difficulties faced by an average consumer in comparing prices; and

- the cost of implementing such a system would be prohibitively high and would be subject to exploitation or "gaming" by major players.

Unlike the retailing of unleaded petrol, which is essentially a commodity with very few differences between outlets, price differences between different grocery retailers would be much more difficult to compare.

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[54] Wen, J.F., Market Power in Grocery Retailing: Assessing the Evidence for Canada, 2001

## 7.2 Comparing prices within store

Q23 Would unit pricing (a requirement that the price per kilogram or per 100 grams etc is displayed on the supermarket shelf or product) improve the ability for customers to compare prices? Should unit pricing be made compulsory? Would unit pricing lower the cost of shopping for customers?

Proponents of unit pricing have estimated savings from its implementation of between 1%[55] and 47%[56] of the grocery bill. The higher range estimates of savings assume that consumers would always opt for the lowest unit price package, regardless of its size, which is clearly an unrealistic assumption. The two more legitimate reasons driving savings estimates are:

- shoppers sometimes mistakenly assume that items sold in a larger size have a lower unit price compared to items sold in smaller packaging; and
- it's assumed that displaying the unit price will entice the shopper to switch to lower priced brands and private label products (which are typically cheaper than branded products).

However, the very same research cited by unit pricing proponents indicates that the benefits of unit pricing are limited – where unit prices are displayed on shelf tags alone, almost all changes resulted from a shift to larger sizes but not to different brands. Brand switching only occurred when stores published "lists" that showed SKUs in increasing unit prices, which is impractical to implement widely.

Enticing customers to switch to larger sizes would not necessarily benefit consumers in the long run. The perishable nature of food items, and the cost of transport, storage and wastage mean that shoppers would not necessarily benefit from purchasing larger sized packages.

By Metcash's preliminary analysis of unit pricing, the estimated cost of implementation is at least $9.9 million, as this will require:

- changes to the IT systems used in price calculation and label printing activities (at a cost of $1.2 million); and
- a one-off change of all price labels in the store as the labels need to be uniform (i.e. it's unlikely that customers would accept a gradual change of signage in a store to unit prices, so that some products have unit prices and some do not). This will result in a further labour cost of $8.8 million.

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[55] Kallir, A. J., Consumers benefit from Unit Price Transparency, Working Paper, Insight Partners, 2008

[56] Passmore, D., Consumers hit by soaring costs and labelling flaws, Courier Mail, March 16, 2008

Ongoing costs are estimated at around $0.4 million per year, associated with additional data entry for unit pricing requirements.

Even higher costs are likely to eventuate if changes to the shelf label size are required.  Most shelf labels at the moment are not large enough to convey both the product price and its unit price.

Metcash ask that the ACCC undertake a comprehensive analysis of the potential costs (including Metcash's estimate of a one-off implementation cost of $8.8 million for independent retailers) against an independent analysis of its potential benefits prior to mandating unit pricing.  Other avenues of achieving the objectives of unit pricing should also be considered, including establish an industry code of conduct that disallows deceptive pricing practices.

# 8 Factors behind rising food prices

A combination of less supply at farmgate, rising domestic and export demand, higher oil and petrol costs, higher labour costs, higher transport costs and various additional regulatory costs have contributed to the increase in food prices over the last 5 years. International comparisons should take into account differences between consumers as well as differences in the economic and regulatory environment.

Q1 What have been the major causes of rising food prices in Australia (e.g. drought, transport costs, etc.)? In particular, what have been major causes of the rising prices of products such as milk, cheese, bread, fruit and vegetables?

Metcash is not a primary producer or manufacturer of grocery products, and hence cannot provide detailed evidence of factors behind rising food prices outside of wholesaling and retailing functions. However, to assist the Commission in its inquiry, the following discussion is provided to highlight the variety of factors that have contributed to rising food prices in Australia.

## 8.1 Factors leading to higher costs

### Less supply at farm gate

There has been less supply at the farm gate due to a number of disruptions to the agricultural sector, such as the drought. According to the Australian Bureau of Statistics, Australia has been suffering from periods of drought since 1864. Between the years 2001 and 2005, the total storage of large dams across Australia reduced by approximately 15% to only 45% (or 39,959 GL). Statistics show that the agricultural industry was the main user of water and used approximately 12,000 GL (65% of total water usage) of water in 2004-2005[57]. As a result of the large usage of water by agricultural companies, any shortage in water will have significant impacts on productivity.

Agricultural output has been significantly impacted by the drought. The volume of grain produced is reduced significantly during periods of drought. The drought will also substantially reduce the quality of the output, and therefore may impact on the saleability of agricultural products. This is despite long-term customer contracts being signed, as customers are generally able to reject product that does not meet the standard of quality required. Farmers' costs have also increased through higher fuel and fertiliser costs, and there are higher costs for feed grain associated with the drought.

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[57] ABS, Year Book, 2008

## Rising demand for agricultural products

Combined with the reduced supply, price has also been influenced by surging demand at the farm gate, the most significantly in respect of:

- Demand for biofuels. An increasing focus on the use of renewable energy globally has also increased the demand for crops such as cereals and canola which can be used to produce ethanol and biodiesel. The 2007 report on biofuels in Australia by the Rural Industries Research and Development Corporation stated that *"A growing ethanol industry…will affect the supply of feedgrain for livestock, particularly in drought years. This will place upward pressure on the price of grain".*[58]

- Rising export demand. Global population growth and improving living standards in countries such as China and India has led to increased global demand for food. This demand factor is demonstrated by the export of rural goods increasing by 1% between December 2007 and January 2008. In addition, the Export Price Index for food and animals increased by 16.5% between 2003-2004 and 2006-2007.[59]

Q70 Do changes in retail grocery prices reflect changes in the prices you pay your suppliers? For example, do retail grocery prices reflect changes in farm gate prices? Please provide details.

However, retail prices do not strictly follow the prices at the farmgate. The correlation between farmgate and retail prices is loose at best, and depends on the product category within fresh food. Reasons for these differences include:

- changes in transport costs;

- changes in packaging / processing costs; and

- supply and demand forces at the retail level.

The following figures illustrate the relationship between farmgate price changes (based on ABARE data), and retail price changes (based on ABS price indices).

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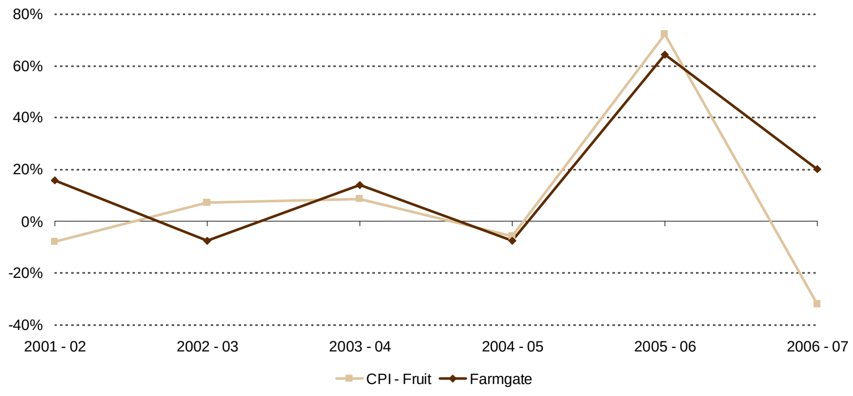
[58] Rural Industries Research and Development Corporation, Biofuels in Australia – an overview of issues and prospects, June 2007

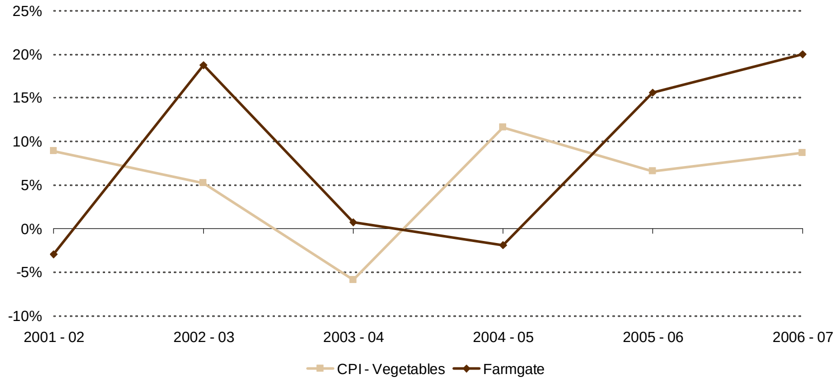
[59] ABS, Australian Yearbook 2008

### Figure 16: Farmgate and retail price changes for fresh fruit



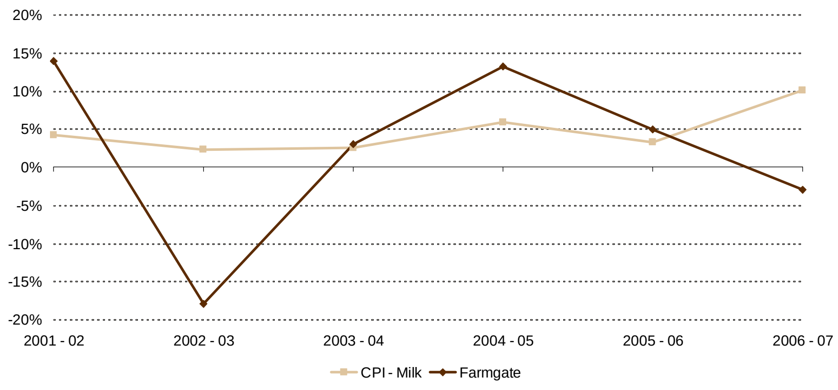

Sources: ABS, ABARE

### Figure 17: Farmgate and retail price changes for vegetables




Sources: ABS, ABARE

### Figure 18: Farmgate and retail price changes for milk




Sources: ABS, ABARE

The above charts indicate that the correlation between farm gate and retail prices is higher in the fruit and vegetable categories compared with milk. This could be due to factors such as:

- the additional processing milk undergoes beyond the farmgate, including value-adding steps(added iron, etc)
- the existence of many different brands of milk, which impacts prices as some brands command a premium
- milk's status as a key value item which can drive in-store customer traffic. Some retailers attempt to maintain low prices for milk in order to attract more customers.

Fruit and vegetables, in contrast, are less value-added products and undergo little processing or branding. As a result, there is a higher degree of correlation between farmgate and retail prices.

## Rising price of inputs

The rising price of inputs into manufactured foods and the rising cost of packaging have also contributed to recent price increases. This has been driven by the rapid increase in crude oil prices, which have almost doubled over the last two years 2006 to 2008. This is relevant to grocery product price increases as crude oil is the source of hydrocarbons which provide fuel and also is an input into plastics and oil.

ABS data shows that the price of materials used in manufacturing increased by a total of 23% between 2002-2003 and 2006-2007 (see Figure 19), while the price of materials used in the food, beverages and tobacco industry have increased by 8.5% between 2001-02 and 2006-07.[60]

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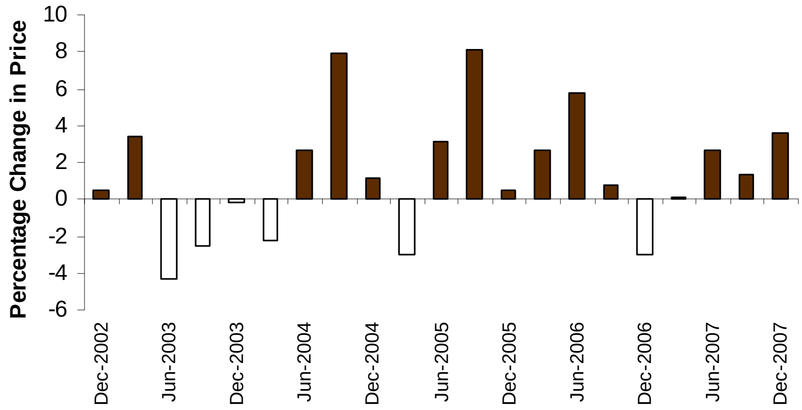
[60] ABS, Australian Yearbook 2008

**Figure 19: Quarterly % changes in the price of materials used in manufacturing industries**



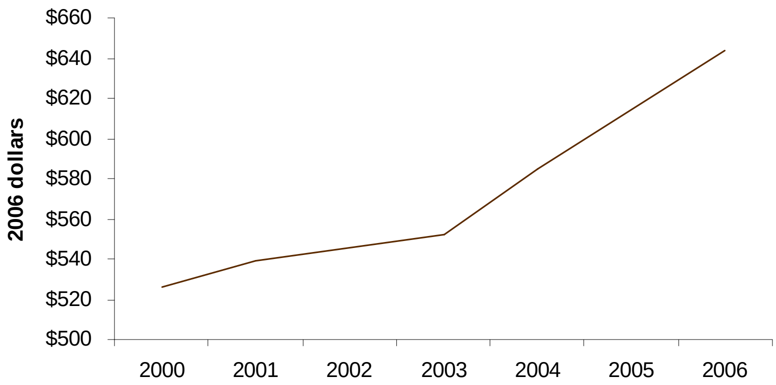

Source: ABS, 6427.0 - Producer Price Indexes, Australia, Dec 2007

The above chart shows that for manufacturing materials, periods of price increases have far outnumbered periods of price decreases. Sustained price increases are likely to have contributed to any rises in the cost of packaged groceries.

## Rising Household Disposable Income

Any increase in household disposable income, pushes up the demand for groceries. Figure 20 below shows disposable household income for Australia.

**Figure 20: Household disposable income**




Source: ABS, 6523.0 - Household Income and Income Distribution, Australia, 2005-06

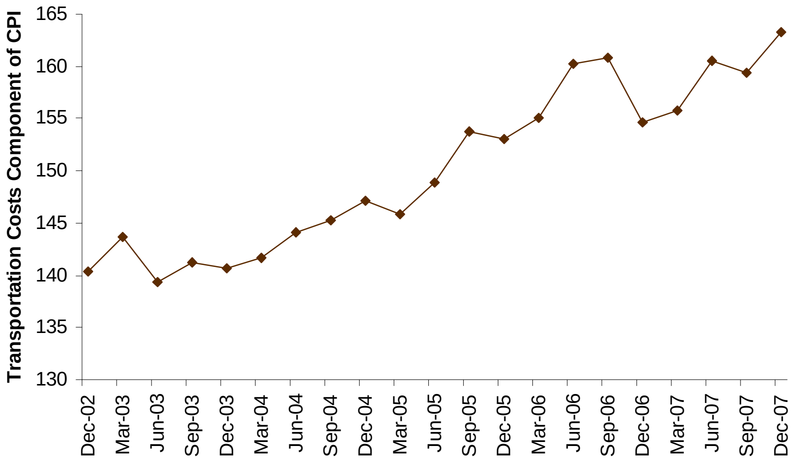
The above chart shows that real disposable household income has increased steadily in Australia over the recent years.

## Rising transport costs

Transportation costs have increased dramatically, primarily due to the surge in the price of automotive fuel. For example, in the December 2007 quarter alone, the price of automotive fuel rose by 7.3%.[61] Through the year to December quarter 2007, transportation costs rose 5.6% with the rise in automotive fuel (+14.3%) being the most significant contributor to the increase. There were also rises in the price of motor vehicle repair (+2.9%), other motoring charges (+5.2%) and motor vehicle parts and accessories (+5.4%)

The following graph shows the increase in transportation costs over the last 5 years.

**Figure 21: Transportation Costs component of CPI, 2002-2007**




Source: ABS, 6401.0 - Consumer Price Index, Australia, Dec 2007

The above chart shows that transport costs have increased sharply over the last five years, driven by higher petrol prices, lower availability of drivers and broader infrastructure constraints.

61: ABS, Dec 2007

## Higher labour costs

Higher labour costs have put upwards pressure on grocery prices, as labour is an essential input into many supply chain functions. Between 2002-03 and 2006-07 the total hourly rates of pay excluding bonuses for all sectors grew by a total of 16.5%.[62] The increase in the seasonally adjusted index for the year ending December 2007 for all employee jobs in Australia was 4.2%.[63]

## Higher regulatory costs

There have been numerous changes in the regulatory environment which have imposed additional costs on supply chain players, including, among others:

- Dairy Adjustment Levy: In 2000, an 11c per litre milk levy was introduced by the Dairy Adjustment Authority to repay the Australian Government for assistance to the dairy industry upon deregulation of the market milk sector.[64]

- Sugar Levy: A 3c per kg sugar levy was introduced in 2003 to help fund a $444 million sugar industry rescue package. However, this was abolished at the end of 2006, which should have allowed manufacturers to pass this tax cut through to their products.[65]

- Import Restrictions: Commercial importers of food such as fresh fruit and vegetables or food containing milk, egg or other animal products need to obtain an import permit prior to importing the food. Imported food must also meet the requirements of the Imported Food Control Act 1992 (Cth) regulated by the Imported Food Inspection Scheme.[66] In addition, the importation of certain food is prohibited under the Customs Act 1901 (Cth). These restrictions decrease the supply of food in Australia, which has the effect of increasing the price of groceries.

- Container Deposit Legislation: South Australia now has a refund of 10 cents per recyclable container (raised from 5c in February 2008).

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[62] ABS, Australian Yearbook 2008

[63] ABS, Dec 2007

[64] Department of Agriculture, Fisheries and Forestry, http://www.daff.gov.au/agriculture-food/levies/dairy, accessed 11/04/08

[65] ABC News Online, http://www.abc.net.au/news/newsitems/200611/s1795843.htm, accessed 27/03/08

[66] Australian Quarantine and Inspection Service, http://www.daff.gov.au/aqis/import/food, accessed 27/03/08

The introduction and reform of legislation, regulation, "voluntary" schemes and codes of practice have resulted in a higher regulatory burden, particularly for independent retailers. This has put an upward burden on prices as businesses must devote funds and human capital to ensure their compliance with regulatory requirements. Some of the key regulations introduced or changed in the last 5 years include:[67]

- Occupational Health and Safety (OH&S) laws;
- health/hygiene/food safety laws;
- tobacco legislation;
- WorkCover; and
- Country of Origin labelling.[68]

## 8.2 Offsetting factors

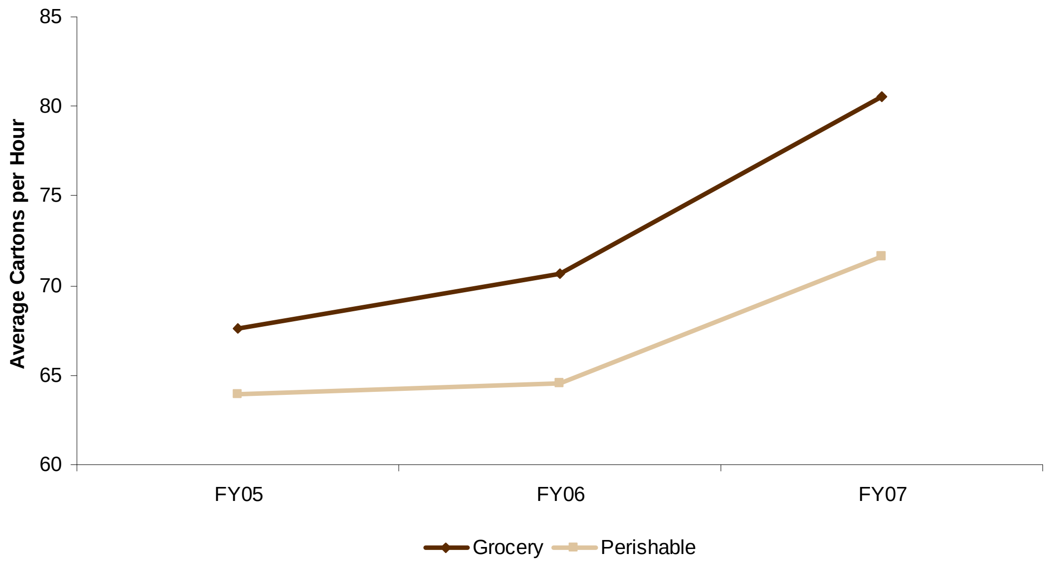
### Productivity Improvements

It should be noted that the cost increases identified above have been somewhat offset by rising levels of productivity resulting from supply chain improvements. For example, Metcash has invested in analysing the productivity of its warehousing staff to improve overall productivity through investments in areas such as the implementation of voice-pick in its warehouses. This is illustrated in the graph below that shows the increase in the number of cases processed by Metcash's major warehouses from April 2004 to April 2006.

[67] NARGA, Reducing the regulatory burden of business, p 3

[68] New Food Standards relating to the labelling of the country of origin of food were introduced into the Food Standards Code, governed by Food Standards Australia New Zealand, on 8 December 2005

**Figure 22: IGA>D Productivity Analysis**




Source: Metcash analysis

Metcash has invested heavily in a state of the art supply chain that will enable it to further reduce its CODB. The $100m investment will:

- Improve inventory management,
- Shorten order-to-delivery cycle times, and
- Improve productivity.[69]

## Exchange rate changes

Also, the appreciation of the Australian dollar has led to a reduction in the price of imports coupled with higher volumes of imports. The Trade Weighted Index (which measures average value of the Australian dollar compared with currencies of Australia's major trading partners) increased from 51.4 in February 2003 to 66.8 in March 2008.[70] Between 2004-05 and 2006-07, imports increased 16.8% in volume terms.[71] The rising volume of imports (which are declining in price due to appreciation of the Australian dollar) should somewhat offset price increases in domestic products. The relative price of imports and exports are shown in Figure 23.

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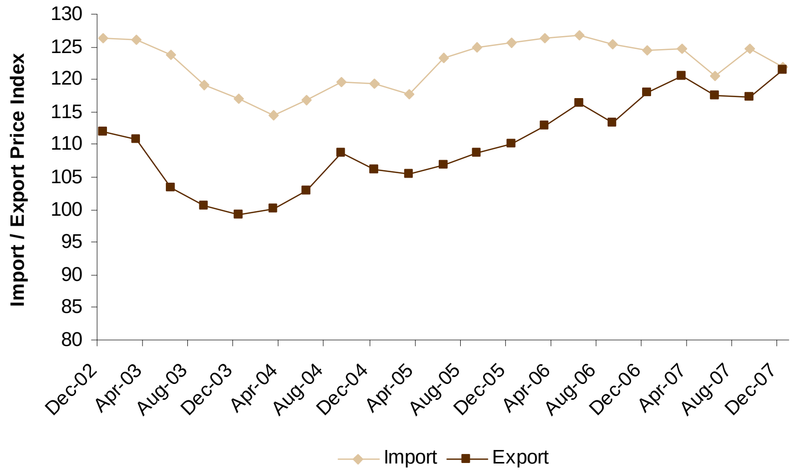
[69] Metcash 2007 results presentation

[70] Source: RBA website

[71] ABS 2504.0

**Figure 23 Import / Export Price Index for Food and Live Animals, 2002 – 2007**




Source: ABS, 6457.0 - International Trade Price Indexes, Australia, Dec 2007

The above chart shows that as import prices have somewhat declined since mid 2006, while export prices have steadily increased.

## 8.3 Value of international comparisons

Q2 Do the OECD comparisons accurately reflect the relative rates of food price inflation in Australia and the OECD countries? Are there other more relevant comparisons? Are there a more appropriate set of countries to compare Australia's food price inflation?

Different countries have a plethora of factors which lead to substantial differences in the structure of grocery retailing. The value of any extensive cross-country comparison of grocery prices would be limited due to differences in:

- Consumer tastes and shopping behaviour
- Population size / density;
- The regulatory environment, including import restrictions for agricultural produce.
- Exchange rates;
- Different products and pack sizes;
- The role of tax in food prices; and
- Different property markets and planning regimes.

There would also be value in analysing the degree to which comparisons recognise consumer substitution between different goods in response to price changes. For example, the degree to which consumers substitute between different types of fruit and vegetables depending on seasonal availability, and between lower value-added and higher-value added products (such as plain milk compared to milk with added calcium) depending on their relative level of income, should be assessed and examined.