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Public Submission (Part A) to ACCC Grocery Inquiry

11 March 2008



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Andrew Reitzer
Chief Executive Officer

11 March 2008

Grocery Prices Inquiry – Submissions
Australian Competition and Consumer Commission
Via Email: grocerypricesinquiry@accc.gov.au

RE: ACCC Grocery Inquiry

Dear Mr Samuel

We welcome the opportunity to participate in this important inquiry into the competitiveness of retail prices for standard groceries.

We will be making our submission in two parts. This document forms Part A of our submission, which provides:

- an overview of Metcash and its role in the grocery retailing industry; and
- an outline of the key issues we would be addressing in the full submission (Part B) we will be making on 11th April, 2008 .

We have kept this document brief as our upcoming full submission (Part B) will provide more details and address the questions posed by the Commission in the Issues Paper for this inquiry.

We understand the importance of this inquiry, and aim to provide a high quality submission to inform the Commission's task.

Kind Regards

A handwritten signature in black ink, appearing to read "A. Reitzer", is enclosed within a large, loopy, oval-shaped flourish.

Andrew Reitzer

Glossary

ALM	Australian Liquor Marketers
CW	Campbells Wholesale
EBITA	Earnings before interest, tax and amortisation
EDLP	'Every day low pricing' – pricing strategy emphasising relatively constant prices over time
Hi-Lo	Pricing strategy emphasising temporary price reductions
IGAD	IGA Distribution
IGAF	IGA Fresh
MSC	Major supermarket chain
SKU	Stock keeping unit – number of particular variations of an item
TPR	Temporary price reduction

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1 Structure of this submission

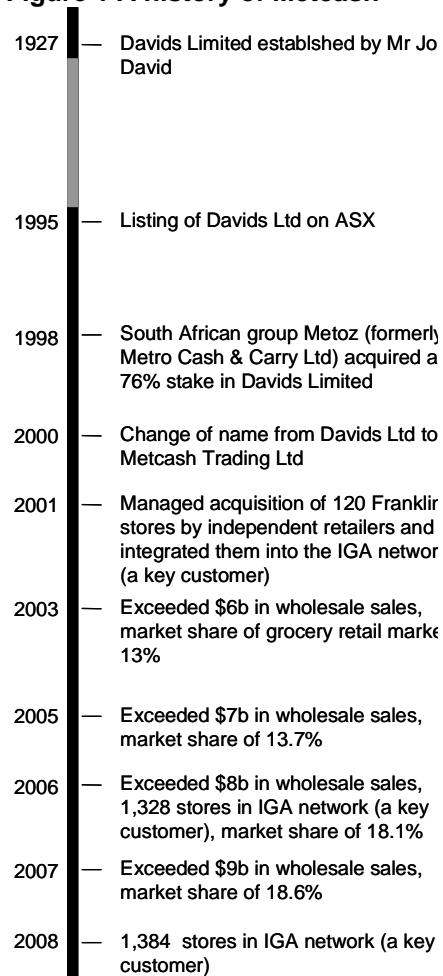
The Metcash submission to the Inquiry will be made in two parts. This document forms Part A of our submission, in which:

- Chapter 2 provides an overview of Metcash, its structure and its key customers; and
- Chapters 3 to 5 provide an outline of the key issues that we will be addressing in the upcoming full submission (Part B) we will be making on 11th April, 2008. These messages include:
 - The Australian grocery retailing market is highly concentrated.
 - Independent retailers do add competitive tension in those markets in which they have a presence (e.g. a Supa IGA).
 - Scale is a key advantage in the grocery market, however lower costs achieved along the supply chain would not be passed on to consumers without enough competitive tension in the grocery retailing market.
 - The Australian grocery market is characterised by extreme Hi-Lo promotional activity (as opposed to EDLP strategies).
 - Independent retailers maintain competitive tension in the grocery retailing market through their intensive promotional pricing and focus on a differentiated retail offer.
 - The greatest impediment to increased competition in the retail market, through a more significant independent retailer presence, is access to suitable locations for Supa IGAs.

Our upcoming full submission (Part B) will provide more details and address the questions posed by the Commission in the Issues Paper for this inquiry.

2 About Metcash

Figure 1 A history of Metcash



Source: Presentations to investors

Metcash is a marketing and distribution company in the food 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 \$3.38 billion at 3 March 2008.

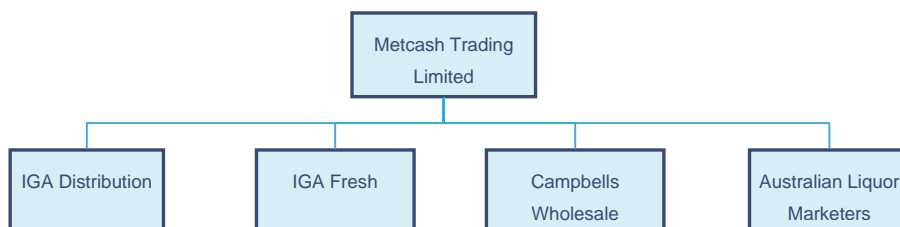
Building a strong independent retail and liquor industry is the core focus of Metcash. If our customers (the independent grocery and liquor retailers) are not successful, we are not successful. We continue to focus on building a differentiated competitive retail offer for our independent retailers.

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

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

Our organisational structure

Figure 2 Metcash pillars of business



Metcash has four pillars of business, for which we act as a focused buying group:

- **IGA Distribution (IGAD)** is a grocery wholesaler serving approximately 4,500 independent retail grocery stores (including IGA branded stores) across Australia. IGAD operates 5 major distribution centres across 5 states, carrying dry, chilled and frozen grocery products. IGAD 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 as part of the Foodland

Associated Limited (FAL) and operated as a division of IGAD until it was formally established as a separate division in November 2007. We have plans to grow this business to enhance the service, quality and price proposition of fresh produce to the independent grocery retail market in Australia. As of the end of FY07, over 240 stores are serviced by IGAF.

- **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 independent convenience stores such as 7-Eleven. CW caters to some 70 000 small business customers providing a wide range of products (groceries, 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 group is presented in the table below.

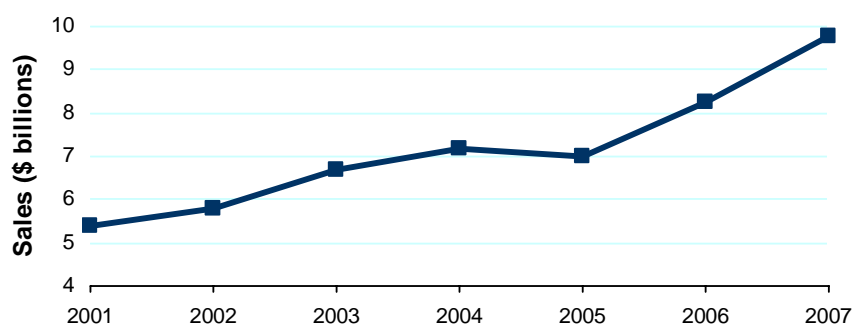
Table 1 FY07 Financial information for Metcash by division

FY07 (\$bn)	IGAD	IGADF	CW	ALM	Metcash Total
Wolesale 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 IGAD Fresh included in IGAD for FY07

Figure 3 on the next page illustrates the strong sales performance of Metcash as a result of it being focused on supporting and growing the independent retail sector which it serves.

Figure 3 Metcash historical sales FY01 – FY07



Our distribution model

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

- Direct purchases 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 including:

- Direct from farm gate (fresh produce only);
- Direct from markets (e.g. Flemington);
- Direct from domestic manufacturers/suppliers; and / or
- Direct from overseas manufacturers/suppliers.

We provide value for our customers through our ability to obtain competitive prices from suppliers, our service and the quality of our support for their businesses.

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 on the next page.

Table 2 IGA network overview

Format	No. Stores	Key Market	Avg. floor space	Avg SKUs
Supa IGA	416	Major shop (e.g. weekly/fortnightly)	1,400m ²	25,000+
IGA	719	Top-up shops	600m ²	12,000
IGA Express	249	Convenience	220m ²	3,000

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

- Brand and marketing compliance; and
- Supply arrangements.

The total annual turnover (at retail) of the IGA Network has been estimated to be approximately \$7.7b.

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 its 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 their customers.

As the 'Champion of the Independent Retailer', Metcash is committed to supporting independent retailers by providing a comprehensive range of services. We provide a series of optional extra support services which include:

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

- In-store retail training;
- A range of specialist service personnel including channel managers, 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 other 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 acts as the primary supplier of FoodWorks, serviced by the IGAD division. FoodWorks operates under an independent co-operative 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. The FoodWorks co-operative has approximately 700 stores nationally and turnover of approximately \$1.35b annually. Metcash, via IGAD, have entered into a supply contract with FoodWorks.

- **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, have 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 stores located in Victoria, New South Wales and Queensland. Approximately half of these 7-Eleven stores also sell fuel.

3 Overview of the grocery market in Australia

The Commission is interested in understanding the supply chain and information about the grocery market in Australia. Our upcoming Part B submission will provide:

- An overview of the grocery supply chain in Australia, including the contribution of each step in the chain to the build-up of the final retail price of groceries.
- An explanation of the fact that there are many different ‘markets’ for groceries in Australia as driven by:
 - geographical location; and
 - different types of ‘shopping events’ for which customers have different needs.
- An explanation of the most appropriate ways of measuring the shares of grocery retailers.
- Quantitative estimates of shares of grocery retailing. Our view is that the market for grocery retailing is highly concentrated.
- An assessment of whether a less highly concentrated market would be sustainable in Australia, including an analysis of the level of concentration in comparable overseas grocery retail markets.

4 The importance of independent retailers to maintaining competitive tension

The Commission is interested in examining where, in the supply chain, costs and prices are increasing. In our upcoming Part B submission, we will put forward the view, backed by evidence, that:

- The competitive tension that independent retailers add, particularly the Supa IGAs, is evidenced by the pricing zones adopted by the MSCs, which do not reflect cost differences but rather the level of local retail competition.
- In those markets in which they have a presence, independent retailers (such as a Supa IGA) contribute significantly to maintaining competitive tension to keep prices low for customers. This is through their:
 - intensive promotional pricing;
 - competitive shelf prices; and
 - competitive advantage in their retail offer including:
 - personal service
 - niche ranging
 - community donations
 - convenient shopping experience.
- Lower costs achieved along the supply chain would not be passed on to consumers without enough competitive tension at the retail end.
- The market for grocery retailing is highly concentrated, with the MSCs now accounting for a very significant share of the retail market.
- Competitive tension is lessened without the presence of a 'third force' retailer (such as a Supa IGA) in the market. The main impediment to independent retailers establishing a more significant position in the market is a lack of access to suitable sites, as:
 - most existing sites are already occupied by MSCs; and
 - MSCs often leverage their relationships with landlords to prevent landlords from offering suitable new sites to independent retailers.

5 Pricing

5.1 Factors contributing to rising food prices

The Commission is concerned with the level of food price inflation in Australia and is interested in understanding the causes of rising food prices. In the upcoming Part B of our submission, we will provide:

- Our view on whether the OECD comparison (Figure 1 in the Commission's Issues Paper) is appropriate.
- An analysis of the various factors that have contributed to rising food prices, including:
 - impact of droughts / floods on supply at farm gate
 - changes to demand at farm gate (due to rising export demand, biofuels, etc)
 - changes in the price of inputs to manufactured goods
 - changes in the price of packaging
 - changes in the price of transport (fuel, congestion, etc)
 - changes in labour costs
 - changes in the regulatory environment (milk levy, sugar levy, import restrictions, deposits)
 - changes in the regulatory burden on supply chain participants (e.g. labelling requirements)
 - changes in levels of productivity (e.g. more efficient logistics)
 - changes in the value of the Australian dollar
 - any change in the profit margins for primary producers, manufacturers, wholesalers and retailers.
- An analysis of the difference in the rate of price increases between different retail markets in Australia, and any relationship between the level of competition in a particular market and the rate of price increases by retailers in that market.

We would aim to show that the higher the number of retail outlets in a particular market, the more competition between retailers in the area to keep prices low. Ultimately, customers benefit from lower food prices due to a healthy level of competition in the retail market.

5.2 Communicating prices to customers

The Commission is interested in how price information should best be communicated to consumers, and the potential merits of unit pricing. Grocery retailers currently spend hundreds of millions of dollars each year communicating price promotions as part of the vigorous Hi-Lo competitive environment. In our upcoming Part B submission, we will provide:

- An analysis of the unique characteristics of Australia's trading environment (i.e. its Hi-Lo focus instead of EDLP).
- An overview of market research on the shopping habits of Australian consumers, including how they typically gain information on price and react to pricing changes.
- A description of the factors on which retailers compete, including price, quality, range, service and other attributes, and the relative importance of these factors to different customers.
- An analysis of the potential costs and benefits of unit pricing, including:
 - the likely level of its usefulness in saving money for consumers; and
 - the cost of implementation including necessary signage changes. Our view is that a large implementation cost would be imposed on retailers, particularly small retailers, if unit pricing is mandated.
- Metcash is not opposed to increasing the level of formal price monitoring in the market, but suggest that a more detailed evaluation of how a price monitoring system would work in practice is required. We will provide an outline of the potential costs and benefits of a government run price monitoring system, including:
 - the likely level of its usefulness in saving money for consumers; and
 - the cost of implementing such a system. Our view is that such a system would be difficult to implement due to difficulties such as accounting for:
 - frequent, multiple price changes which characterise Australia's Hi-Lo retail market;
 - differences in SKUs carried between retailers;
 - quality differences within a single product (particularly relevant for fresh produce); and
 - other differences between each store's retail offer which are important for consumers, including factors such as convenience, quality of service, etc.

5.3 Efficient pricing

The Commission is interested in the impediments to efficient pricing in the grocery supply chain. In our upcoming Part B submission, we will be putting forward the view, backed by evidence, that:

- Independent retailers such as Supa IGAs intensify the level of competition in the market. There is evidence that where a Supa IGA exists in the catchment area, MSCs' price zones are adjusted to maintain competitiveness. The lack of access to suitable sites to expand to is the main reason why this 'third force' is not obtaining more market share.
- Generally, competition between players in the supplier and wholesale markets mean that efficient prices are obtained. However, the current degree of concentration in the retail market means that efficient prices would not be passed on to customers without the significant 'third force' of independent retailers.
- Economies of density, scale and scope are very important in achieving lower costs in the grocery supply chain. This is because larger wholesalers or retailers are able to:
 - buy in bulk;
 - provide certainty through consistent orders;
 - achieve warehousing and transport scale economies;
 - offer suppliers distribution of their product over a wider network; and
 - achieve other network or scale efficiencies in areas such as compliance and administrative support.
- The MSCs enjoy significant economies of scale, density and scope, however any efficiency gains achieved would not be passed on to customers without an adequate level of competition in the market for grocery retailing.
- The main impediment to cost savings being passed along to consumers in many markets is the lack of competition on the retail end. Australia is large enough to sustain a 'third force' that achieves similar scale efficiencies to the MSCs.