

**Franklins Pty Ltd
Response to ACCC Inquiry
Into the Competitiveness
Of Retail Prices for
Standard Groceries
Volume 1**

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Background to Franklins

Franklins is a wholly owned subsidiary of Pick 'n Pay Stores Limited, South Africa's largest and most successful supermarket chain that was founded over 40 years ago.

In 2001, following the divestment of Franklins Limited by Dairy Farmers Limited, Pick 'n Pay Stores Limited acquired 50 stores and the brand "Franklins" from Franklins Limited. At the same time as acquiring these 50 stores Pick 'n Pay also acquired a further 20 supermarkets which were branded Fresco Supermarkets.

Franklins currently operates a chain of 80 supermarkets, 74 of which are corporate owned and 6 franchised stores in New South Wales.

When the current Franklins venture was commenced in 2001 the decision was taken to enter into a three year wholesale supply contract with Metcash ("Metcash"). During the term of this contract it became evident that it was uneconomical for Franklins survive as a retailer competing with Woolworths and Coles while buying from a wholesaler. Consequently, in order to survive Franklins established its own warehouse and distribution capabilities in 2005 and terminated its relationship with Metcash.

On conclusion of the supply contract with Metcash it became apparent to Franklins that various discounts and allowances that should have been passed onto Franklins by Metcash were in fact not passed onto Franklins. This issue is still the subject of court proceedings between Franklins and Metcash.

A. Structure of the Grocery Industry

1. Questions on grocery retailing

- 1. 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?***

In our view the major causes of rising food prices have been a combination of factors which include:

- the effects of drought in Australia,
- a global shortage of food products as a consequence of a diversion of grain crops to bio-fuel production
- increases in the prices of commodities such as oil and tin both of which are extensively used in the production of food packaging
- the ever increasing price of petrol and its direct impact on the cost of distribution

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

The major changes in the grocery retailing industry over the past 5 to 10 years include:

- The demise of Franklins Ltd under the ownership of Dairy Farmers Ltd which resulted in the acquisition of Franklins by Pick 'n Pay Stores Ltd. Woolworths experienced substantial growth in overall scale and market share as a direct result of their acquisition of a substantial number of stores from Franklins Ltd
- During the period in question the emergence of Aldi within the Australian grocery retailing environment has resulted in a significant shift towards private and confined label grocery products
- The acquisition of Foodland by Metcash has resulted in the elimination of a regional supermarket chain in Queensland and West Australia and has resulted in a further concentration of Metcash's share of the grocery wholesale market
- Metcash has made several investments in small independently owned supermarket chains
- The introduction of petrol discount shopper docket schemes by the MSC's has resulted in a significant change in the overall competitiveness of the grocery retailing industry

This inquiry is focused on the grocery retail industry however; comment on the concentration of the liquor retail industry is warranted. Over the past five or so years there have been numerous acquisitions of liquor retailers, pubs and hotels by both Coles and Woolworths that have resulted in a substantial concentration of market share and market dominance in the hands of these retailers.

3. *How important are economies of density, scale and scope in grocery retailing?*

Economies of density, scale and scope in grocery retailing are extremely important in grocery retailing. Without these economies the costs to operate a profitable and competitive retail chain is prohibitive. This is most prevalent in relation to the ability to effectively advertise and market the retail chain and the ability to source and distribute products to retail outlets in an efficient and cost effective manner.

4. *How does the structure of grocery retailing differ between metropolitan, regional and country areas?*

Competition within metropolitan areas is generally very competitive as major supermarket operators are well represented and compete vigorously. This situation varies within regional and country areas, where there is less vigorous competition, some prices tend to be higher than in metropolitan areas.

5. *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?*

The overall profitability of grocery retailers is dependent on the overall scale of operations and the general levels of efficiency at which the retailer operates.

Franklins' experience of buying groceries from a wholesaler is that there is insufficient profit margin to enable a retailer to compete with the MSC's and achieve adequate levels of profitability.

Store level margins and overall profitability is a function of a number of factors which include the mix and volume of product sold and the overall overhead structure of the store.

2. Questions on grocery wholesaling

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

We do not concur with the Commission's description of the grocery wholesaling industry. Since the sale of Australian Independent Wholesalers by Woolworths and the acquisition of Foodland by Metcash, Metcash is the only grocery wholesaler that operates in Australia.

Coles, Woolworths, and Aldi have warehouses that service and supply their respective stores. They do not supply third party or independent supermarket retailers. Franklins supplies its corporate stores and its franchisee stores through its central distribution centers.

B. Consumer Behaviour and Choice of Grocery Retailer

1. Questions on consumer behavior and consumer choice of grocery retailers

7. *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)?*

In New South Wales customers have substantial choices of grocery retailers from which they can purchase their groceries. These choices include Franklins, Woolworths, Coles, Aldi and independent retailers. In addition to the grocery retailers listed there are many grocery products that can be purchased from general merchandise retailers such as Big W, K Mart, to a lesser degree Officeworks and from specialty retailers such as Priceline.

In the case of meat, fruit and vegetables and delicatessen lines there are a multitude of independent operators that provide substantial choice for customers in addition to the offers of the MSC's.

- 8. *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?***

Unit pricing is a good tool to assist customers to make informed choices it will not lower the cost of shopping.

- 9. *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)?***

Customers are generally time poor which makes the convenience of a broad range of grocery products being available in a “one-stop” shop an important factor in their decision on where to shop.

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

Price is not the sole determining factor that influences the decision where to shop. The decision is based on a combination of factors which include convenience of location, friendliness of service, broadness of range and price.

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

Consumers gain information on the pricing of grocery retailers through extensive advertising undertaken by grocery retailers in a variety of formats which include weekly handbills distributed by way of letter-box drop and extensive advertising in television, radio and newspaper media. In addition to these forms of communication of pricing there are regular independent pricing surveys undertaken by consumer bodies that report on the pricing of the grocery retailers.

2. Questions on the pricing strategies of retailers

- 12. 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?***

Grocery retailers undertake extensive advertising and promotion programs which cover an extensive range of product to communicate their price offers to consumers.

- 13. 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?***

Pricing surveys are undertaken by a number of independent research companies which facilitate price comparisons between the various grocery retailers. These independent surveys are supplemented with price comparisons of advertising of competing retailers and regular in-store price checking. Price comparisons are undertaken across a broad range of products and are undertaken on a regional and local basis as appropriate.

- 14. 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?***

Following the introduction of the petrol shopper docket programs by Coles and Woolworths Franklins' share of the New South Wales grocery market experienced a drop of 13.5%.

Franklins' loss of market share is directly attributed to the petrol shopper docket schemes on a company wide basis. In certain isolated cases Franklins has attempted to establish localized petrol shopper docket programs. These have had limited and varied success.

The overall effect of the petrol shopper docket programs has had a dramatic effect on the ability of smaller grocery retailers to compete on a level playing field with Coles and Woolworths.

C. Competition in Grocery Retailing

1. Questions on competition in grocery retailing

15. 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”)?

Coles and Woolworths compete vigorously against each other and within New South Wales, where Franklins is represented we are of the view that a further competitive option is available to consumers.

Our experience of buying through Metcash is that it is not always possible to compete against the MSC's on price and remain profitable. The Metcash into store price, in many instances, did not allow sufficient gross margin to be earned and still remain competitive.

There have been numerous media reports of recent times that attempt to expose the MSC's for the negative effect that they have on independent supermarket operators in small country towns. The issue that these media reports fail to raise is why Metcash does not provide the necessary support to their customers who trade under the IGA banner to enable them to compete effectively with the MSC's.

16. 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?

As indicated above the move into petrol retailing and the adoption of petrol shopper docket schemes has significantly altered competition in grocery retailing as it provides

Coles and Woolworths with a substantial market advantage that is not available to other market participants. The effect of this is not limited to grocery retailing but extends to petrol retailing as well. Since Coles and Woolworths have moved into petrol retailing they collectively now dominate the petrol retail landscape and have forced many independent operators out of business.

17. 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?

Franklins' policy is to establish pricing which allows it to actively compete with the MSC's. Pricing is generally set across the chain, however in order to compete with other retailers zone pricing is adopted in certain areas.

Establishment of pricing is done within the central buying office and where appropriate changes are made based on input from store management.

18. 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.)?

It is Franklins' policy to maintain a single pricing level across its chain of stores. In certain instances it has had to adopt zone or regional pricing in order to remain competitive in certain areas in line with the practices of the MSC's.

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

The Australian grocery industry could sustain a supermarket chain of similar size to Coles and Woolworths. This would however require a leveling of the playing fields in so far as structural issues such as the number of sites and locations for the establishment of new stores.

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

To establish a new grocery outlet requires the following key inputs;

- An appropriately zoned site located in an area with a sufficiently large population base within a catchment area that warrants the establishment of a shopping centre
- The proposed site needs to be easily accessible for shoppers

21. 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.

Access to new suitable sites is a significant impediment to expansion of supermarket chains. Local planning and zoning restrictions tend to bear little resemblance to commercial reality, areas that are zoned for retail uses are not necessarily in appropriate locations. Additionally, Government initiatives to increase population densities have created demands for retail space that cannot be met under existing zone criteria. Rezoning applications are a long and slow process which further hampers the ability to respond to consumer demand. This is particularly relevant in inner city areas where higher population densities are being encouraged where there are generally smaller lot sizes that require amalgamation to provide sufficient land to accommodate a supermarket development.

Local council development approval processes are too complicated and are generally allocated to junior town planners who have no real understanding of the cost of their delays on the overall cost of the ultimate development of the relevant shopping centre.

Over the past few years there is a clear pattern emerging of both Coles and Woolworths buying regional shopping centers where they do not have an existing presence. This strategy has very serious long term implications for the ongoing competitiveness within the grocery industry. As this strategy, in our view, will allow Coles and Woolworths to establish their own new supermarkets by refusing to enter into new leases with existing supermarket operators that currently occupy these centers.

While this practice does not have a direct impact on Franklins' ability to find new sites it does bring into serious question whether Franklins will be able to retain its premises in shopping centers that it currently occupies which have been purchased by either Coles or Woolworths.

22. 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?

Major shopping centers seem to be willing to offer additional space to accommodate either Coles or Woolworths where one or the other is not represented and in some circumstances Aldi has been given space.

There have been several situations where Franklins and either Coles or Woolworths has been represented where space has been developed or made available to Coles or Woolworths. In all of these situations there has been a sharing of sales between three supermarkets rather than two and no real increase in overall market size.

Consumers generally benefit in these circumstances due to vigorous competition between supermarket operators.

D. Competition in Grocery Wholesaling

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

There are commercial advantages that flow from the vertical integration of warehousing and distribution capabilities within retail operations. In fact, it is the experience of Franklins that without such vertical integration it is not possible to effectively compete against Coles and Woolworths.

The key advantage of vertical integration is the ability for the overall reduction in the cost of doing business and the cost to distribute product to retail outlets to be passed onto consumers through more competitive pricing.

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

As discussed previously, as there is only one grocery wholesaler in New South Wales, there is no option available to a small retailer other than to establish its own central distribution facilities in order to bypass the only grocery wholesaler i.e. Metcash. This was indeed the case of Franklins at the time of making its decision to terminate its relationship with Metcash.

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

Large scale entry into grocery wholesaling is unlikely. The reason being, that Metcash has an effective monopoly of the grocery wholesaling industry and has secured its position through contracts that impose extremely onerous and restrictive break conditions on its customers, the independent supermarket operators trading under the IGA brand. It is therefore unlikely that an entrant into the wholesale grocery market would be able to sustain a sizeable operation.

E. Competitive Position of Small and Independent Grocery Retailers

1. Shopper docket schemes

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

Franklins established a customer loyalty program in 2007 in an attempt to counter the effects of the petrol discount schemes of Coles and Woolworths. Early indications of the program are very pleasing. However, given the relatively short time that the program has been in operation it is difficult to gauge its full effect on the business.

3. Conduct of grocery retailers

27. Please describe any such conduct (including specific instances) and the effect of the conduct on competition in grocery retailing.

Our comments in relation to petrol discount schemes, the expansion of Coles and Woolworths into liquor retailing and the practice of acquiring shopping centers by these retailers are relevant to this topic.