Supplementary Submission to

The Australian Competition and Consumer Commission Inquiry into the competitiveness of retail prices for standard groceries

by

Coles Supermarkets

3 June 2008

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1 Overview

1.1 Introduction

This submission is a supplementary submission to Coles' public submission dated 28 March 2008.

In this submission, Coles wishes to respond to a number of issues which have been raised in submissions made by other interested parties to the Australian Competition and Consumer Commission ("**Commission**") as part of the Inquiry into the competitiveness of retail prices for standard groceries, or have otherwise been put to Coles by the Commission in the course of the public hearing on 26 May 2008.

The purpose of this submission is therefore to respond in a comprehensive manner to issues that have been raised and to further expand on Coles' previous public submission.

1.2 Key issues from Coles' perspective in relation to the Inquiry

A sustainable business for Australia and who we are

Coles appreciates that the Commission was expressly requested on 22 January 2008 to conduct a review of a number of matters by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs and also that the Commission has released an Issues Paper in relation to matters that it considers relevant.

However, Coles believes that many of the submissions made to the Commission over the past several months by other interested parties do not reflect on the positives of the Coles supermarkets business and what Coles seeks to achieve for its customers.

To date, the Inquiry has primarily focused on criticisms of the major grocery chains. This focus tends to overlook the positive aspects of Coles' business operations, as outlined in Coles' public submission, and does not allow proper consideration to be given to the key objectives Coles seeks to achieve in the conduct of its business – namely, providing services its customers want, treating its suppliers fairly and reasonably, and providing shareholders with a satisfactory return.

Therefore, in this submission, in addition to addressing some of the issues raised in the Inquiry, Coles seeks to put into context its grocery business and the complex nature of the grocery industry.

The supermarket industry is highly competitive, with pricing and value influenced by a broad range of competitors, including increasing numbers of independent retailers, speciality food stores and major new entrants.

At a time when food prices are subject to considerable inflationary pressures, largely because of international factors, the scale and

sophistication of major retailers' buying and pricing systems provides an effective mechanism to manage these price pressures on behalf of consumers, by absorbing costs or otherwise mitigating the effect of price rises.

There are other areas of the food value chain that, in Coles' view, are not subject to the same degree of competitive pressure as retail, notably the wholesale sector.

Against that background it is important to understand what is the nature of the Coles supermarkets business.

Coles Supermarkets - who we are

- Coles is part of the Wesfarmers Group.
- Coles supermarkets has approximately 92,000 employees - it seeks to be a responsible corporate citizen and to treat its employees fairly and operate as a responsible business in the communities in which it operates offering employment throughout the country.
- Its parent company, Wesfarmers, has more than 400,000 shareholders.
- Coles is a national, full service business operating across Australia and:
    - has approximately 750 stores;
    - ranges circa 27,000 individual products in a typical store; and
    - has relationships with approximately 4000 suppliers.
- Coles seeks to deal with its suppliers fairly and reasonably and aims to further improve its relationships with suppliers.
- Coles is committed to serving its customers - it has 11 million transactions per week and continually aims to improve its customer service.

Against this background, Coles competes in a dynamic and competitive environment against:

- stores such as Woolworths which also operates nationally;

- stores such as Aldi which use home brands and compete in specific locations;
- smaller grocery chains such as FoodWorks;
- specialist retailers supplying, amongst other things, fruit and vegetables, meat, bread and milk - who can be nimble and focus on differentiating themselves by their products, services and location.

If Coles does not serve its customers well they will leave - as it found when it re-branded Bi-Lo stores. Coles does not have a market position such that it can ignore the requirements or demands of its customers. The industry is highly competitive and customers have alternatives.

Coles is required to balance the needs of each of these stakeholders: customers, suppliers, staff and shareholders, by operating a sustainable business that serves Australian customers in a competitive market. Coles needs to meet the demands of its customers, while also treating suppliers fairly and earning a return to shareholders that is attractive compared to other businesses.

Food price inflation

Coles' earlier public submission included material from FreshLogic, experts in food prices and supply chains. Since then, further evidence has emerged of global pricing pressures in commodities such as wheat, rice and milk[1]. Coles does not wish to address these points in significant detail again, but that analysis made several key points:

- Food price inflation is influenced by global pricing and current supply constraints for inputs such as fuel and staples including rice, meat and dairy products.
- The current Australian CPI treatment may not be appropriate to reflect global changes in food pricing or changes in the way Australians now shop based on convenience and type of goods.
- Competition for consumers' purchasing needs is spread across a range of factors such as price and convenience. Competition for the "share of wallet" which customers set aside for food is spread between grocery chains, convenience stores, speciality food stores and fast food outlets.

[1] See, for example, the recent article in page 5 of The Australian "Overseas sales drive up milk prices. Boom times at farm gate", 17-18 May 2008.

- Coles does not compete with other grocery chains alone. It competes with a range of stores including butchers, fruit and vegetable shops, bread shops and chains focusing on specific items or with chains offering more limited sales propositions such as Aldi.

It is understandable that, in light of these issues, the Government wishes to review certain conditions of competition to ensure the relevant markets are operating competitively and provide the best possible value for consumers, but Coles believes that a fair and transparent review needs to take into consideration that global factors are the major drivers of current food price inflation.

1.3 The conditions of competition

As noted above, the debate about food prices has not to date focused on the nature of competition in this broader sense and the role that Coles plays while balancing the competing interests that arise in a sustainable business.

Various interest groups together with media have criticised the major grocery chains for many things, including creeping acquisitions, property purchases, restrictive covenants in property leases and also for not pricing vigorously enough for consumers or alternatively pricing too vigorously to the detriment of small business. In response to these criticisms, Coles notes the following:

Pricing: Coles prices vigorously against its competitors. However, Coles does not engage in "predatory pricing" in the sense of pricing aimed at driving a competitor out of business or deterring a competitor from entering the industry. With regard to two specific pricing issues that have been raised in the course of the Inquiry, Coles makes the following comments:

- Wholesale pricing is an issue that has been raised at the Inquiry - but while Coles has been asked for a lot of information on this issue, Coles does not consider itself to be a grocery wholesaler, because it does not act as an intermediary between manufacturers/producers and retailers. Wholesale pricing competitiveness is therefore an issue for Metcash, its customers and NARGA.

- Regulatory asymmetry - Coles is concerned that Unit Pricing and other proposals be applied to all participants on an equal basis - whether it is in terms of comparing unit prices or in relation to food origin labelling, there needs to be laws of general application across all supermarket retailers. This regulatory asymmetry needs to be addressed and a phase in of changes to allow all businesses to compete equally without overly burdening small business. Further detail is set out later in this submission.

Supplier relationships: In dealing with suppliers Coles aims to act reasonably and fairly, balancing competing interests. Coles has formal first stage internal dispute resolution procedures in place for suppliers, and if this process does not resolve a grievance, suppliers may also access external second stage dispute resolution procedures under the Produce and Grocery Industry Code.

Property, planning and leasing: A good deal of the debate about competition has suggested that the major grocery chains have sought to shut out competing businesses by land banking or employing other property development barriers to potential market entrants.

Coles leases over 97% of its supermarkets. Hence the opportunity to “land bank” (i.e. to hold land to block competition) is limited. Coles acquires land to facilitate development of short or long term business opportunities. In many leases, Coles has restrictive covenants or “second tenancy” clauses. Such clauses are one aspect of our leases designed to balance the terms of commercial negotiation, protect the amenities of our stores for our customers and allow Coles to establish its business and trade profitability. With long lease terms and limited opportunities for rental to “go backwards” compared to sales, Coles will from time to time require such protection.

These issues are discussed in further detail in this submission.

In terms of overall planning issues, Coles would welcome sensible planning reforms to allow increased new store availability provided these reforms apply equally to all participants.

“Creeping acquisitions”: Coles aims to promote cooperative and positive relations with the Commission and it believes all of its acquisitions over the last few years have been notified to the Commission.

2 Section Two - Pricing

2.1 Introduction

The issue of Coles and other retailers having varying prices as between their stores has been raised in submissions and other public forums. Coles acknowledges that its pricing will vary between stores, consistent with its pricing policy, and considers that this results in lower prices overall, to the benefit of consumers rather than to the detriment of competition. Coles' pricing policy is reflective of the need to operate a profitable business, to present competing value propositions to customers and to meet competitive pressures, all of which need to be balanced at both a national and a local level.

Coles' pricing structure reflects the costs of running a national, full line, full service supermarket, employing over 92,000 employees, typically ranging up to 27,000 products and providing in-store services such as delicatessen and bakery as well as bag packing.

2.2 Coles' pricing policy - general pricing policy

There are three principal aspects of Coles' price setting process:

(a) centrally setting initial standard prices;

(b) making adjustments based on the zone in which a particular store is located; and

(c) responding on an individual store basis to nominated local competitor pricing.

Central price setting process

When new lines are introduced, Coles initially sets its retail prices at a central level. Each pricing decision is based on a variety of factors, which include:

- the profitability desired by Coles (which is an outcome of the consideration of the cost of goods sold and the requirement for a satisfactory return). This is achieved through a mix of both unit profitability and volume;

- the price point of other stock keeping units ("**SKUs**") in the relevant product category, and the price/value position that Coles wishes to offer its customers;

- if Coles sells other size products in a range, the price of the new line relative to the other sizes (see below);

- adjustments to prices to reflect individual state factors (eg freight costs); and

- prices at competitor stores that have been nominated internally as relevant.

For established lines already in the range, competitor prices for the top 1500 items are monitored on a weekly basis and Coles will review its prices for these items weekly on the basis of the results. Monitoring at this central level takes place against Coles' closest national competitors, currently Woolworths, Aldi, Franklins and Super IGAs.

Price zones

Coles' standard prices are then centrally adjusted depending on the zone which applies. Each Coles store is allocated to a particular pricing zone, which will determine the normal selling price it may charge for each product before taking into account any local competitive response.

Zone pricing provides efficiencies in managing competitive pricing across all Coles stores. In effect, zone pricing reduces the workload in Coles stores on individual store managers by adjusting prices for 27,000 SKUs which would otherwise have to be monitored and keyed in by each store individually.

Local competitive response

The final step in Coles' pricing policy is the adjustment of prices on a store by store basis, dependent on local competitive conditions not captured in the central competition checking process.

2.3 Coles' pricing policy - fresh produce

Coles' pricing process for fresh produce follows the general policy outlined above, although changes are applied more frequently due to the dynamics of daily purchasing and supply to stores.

The standard retail price is determined centrally by National or State Buyers, bearing in mind factors such as:

- the volume of stock that growers have and will have;
- current business targets; and
- competitor pricing.

2.4 Promotional Pricing

Promotional pricing is a significant and key part of Coles' customer offer. Coles offers promotions to attract customers and improve market share. In setting promotional prices, Coles will take into account the media it is currently using to support the promotion (eg catalogue, press or electronic). These prices reflect the general approach taken for normal pricing having regard to the pricing zones and the reach of the particular media being utilised.

Each State fresh produce team will also nominate lines to be run as in-store specials, which will depend on product availability by State.

2.5 Clearance Markdown pricing

Pricing decisions also need to be taken in relation to clearance markdowns. These take place at two levels:

(a) at the central level, buyers may need to clear merchandise from stores and distribution centres if a product is overstocked, if a product is being deleted, if it is the end of the season or the product is approaching its use by date;

(b) at store level, teams are authorised to take in-store markdowns (generally, for deleted lines and product approaching its use by date) over and above any centrally set markdowns to reflect the particular situation of the clearance stock at their store.

These markdowns (both centrally set and at store level) may be at or below cost, reflecting the level of stock, its condition and the amount that needs to be cleared.

2.6 Coles' pricing policy - private label brands

Coles' central pricing policy is generally adhered to in respect of private label products. However, there are some different considerations which apply to each of Coles' three private label brands.

"Smart Buy" products

"Smart Buy" products are priced at the lowest comparable competitor price.

In comparing prices with competitors, Coles assesses which products are most directly comparable to its "Smart Buy" items in the eyes of the consumer. It prices these equivalent products against Woolworths, Aldi, Franklins and IGA.

"You'll Love Coles" products

It is Coles' aim to price "You'll Love Coles" products at least 10% less than the benchmark proprietary item.

"Coles Finest"

Pricing is set by reference to individual product attributes and consumer price sensitivity, to reflect the premium nature of the range.

2.7 Pricing policy reflects competitive structure of Australian industry

Coles' pricing structure reflects the costs of running a national full line, full service supermarket, employing over 92,000 employees, typically ranging up to 27,000 products and providing services such as in-store service delicatessen and bakery and bag packing.

It should be apparent from this description of Coles' business and Coles' pricing policy, as set out above, that Coles' pricing reflects its business and the competitive structure of Australian grocery retailing.

There are many different factors that influence the price that Coles ultimately charges consumers, but the general pricing policy reflects that Coles' closest competitors at a national level are substantial national or regionally based retailers. Woolworths is the main individual competitor of these, but Aldi, Franklins and IGA are all important for Coles' pricing decisions at a zone level.

However, the full breadth of retail competition faced by Coles becomes more apparent at a local level, as Coles checks prices against a wide range of other retailers. This supports Coles' contention that it competes at this local level with a larger number of chain and independent supermarkets as well as speciality stores.

Beyond these competitive factors, Coles' prices strike a balance between the needs of its customers and the interests of shareholders.

2.8 Coles' prices are set by reference to the dynamics of competition and its costs

The above description of Coles' pricing policy illustrates how Coles' pricing is set by the dynamics of competition and, in particular, arise from the actual ability of consumers to switch between retailers if Coles does not remain competitive on price, quality, convenience and services. The Bi-Lo experience is a good example.

2.9 Dynamic nature of industry

As detailed in the pricing policy above Coles standard prices are modified to reflect individual factors, including the competitive position in each State and zone, and then to reflect the local competitors' prices being met by each store. This is a dynamic process and reflects as closely as possible the competitive intensity in each local area and the timing of flow through of any weekly product cost increases (fresh produce is adjusted daily) and daily promotional pricing strategies.

Although these local decisions may lead to different prices on the shelves of different Coles stores, consumers benefit overall from Coles' competitive response. Consumers also benefit from retailer price reductions as part of daily and weekly marketing campaigns. For instance, Coles has approximately 2000 to 3000 SKUs on special at any given point in time.

2.10 Unit pricing

Coles considers that it currently provides simple, clear information for customers. It provides a total price and price per unit on a wide range of products, including deli, dairy and most fresh produce (packaged and unpackaged).

Coles also notes that consumers make decisions regarding purchases on the basis of more complex information than just price. For example, they make judgements based on suitability or fitness for purpose, brand and size.

Coles believes that unit pricing will benefit customers if the practice is adopted universally by all supermarket retailers across Australia. If unit pricing is limited to a few retailers, or is introduced other than in a uniform

manner, a scheme could result in more confusion for consumers than it would benefit.

Introduction of a unit pricing scheme will involve considerable cost for Coles and other retailers. Coles strongly endorses an approach that would enable it to roll out any such scheme within a 12 to 18 month timeframe, in which case it estimates its own likely costs would be between $5 million and $10 million. If, however, immediate implementation of the scheme were required, it would be likely to cost Coles closer to $20 million.

The implementation of a unit pricing scheme will need to be supported by industry and government funded awareness programs for consumers.

2.11 Non-price competition

In order to provide additional and complementary competitive differentiation, it is necessary for Coles to compete on factors other than price. The requirement for non-price competition has led to various industry developments.

Examples:

- competition on the range of goods sold, for example convenient, ready to eat foods. This includes ensuring that Coles stocks the products which are most important to its customers, whilst maintaining a diverse offering;
- the introduction of a successful private label strategy, with a wide range of standard and luxury items. Some private label goods are aimed at providing a slightly different product to existing proprietary brands, thereby increasing customer choice (for example, the introduction of the "You'll Love Coles" Belgian chocolate range);
- the introduction by Coles of fuel shopper dockets and other loyalty programs eg FlyBuys, Coles Baby Club and the complimentary Christmas Ideas Magazine, which provide savings and benefits to customers in an alternative way;
- product layouts which make it easy for customers to shop;
- checkout services including, bag packing;
- deli services to provide pack sizes suiting customer requirements not met in pre-packed departments; and
- convenient locations and trading hours to suit customers' busy lifestyles.

Nevertheless, it is keen pricing that provides the greatest value to customers and which is most likely to be rewarded by customer loyalty. Non-price competition acts as a complement to price competition, but cannot replace it.

3 Section Three - Dealings with suppliers

3.1 Introduction

Coles notes the allegations that the major supermarkets, including Coles, have market power or “excessive” bargaining power as against their suppliers, particularly small suppliers, which it is claimed enables the major supermarkets to:

(a) reduce the prices paid to suppliers, without necessarily passing on those savings to consumers; and/or

(b) ignore contract terms and engage in unconscionable conduct in dealings with small suppliers.

Coles considers this view of the competitive dynamics of the industry ignores a number of important factors, including the tension between the competing interests of suppliers and customers.

Coles is only in a position to deal with the treatment of its own suppliers and now provides additional specific responses.

3.2 Bargaining positions of industry participants

Large suppliers

Coles has not been able to source the margins made by its suppliers on their Australian sales, as many of them are international companies. Coles considers it likely that a comparison between its margins and the margins of its suppliers would not support a contention that Coles enjoys market power relative to them and that this will be seen by suppliers having margins well above those in Coles’ supermarkets.

Small suppliers

The allegations that retailers enjoy market power against smaller suppliers rely on statements such as the following, to the effect that farmers are price takers:

> *“As a consequence of their large share of the market, the retail chains are price makers; and growers are generally price takers. While we are aware that there are many growers who deal with the retailers as direct suppliers, there is a significant majority who are unwilling to deal directly with the major supermarkets, or unhappy about major issues relating to their business transactions with the retail chains.”*[2]

> *“Farmers have little market power and are known to be price takers; taking whatever price is imposed by the big retail chains, wholesale agents, processors and the world markets. There is also a clear trend*

2 Horticulture Australia Ltd, *Public Submission to the ACCC grocery inquiry by Horticulture Australia Council* (11 March 2008) at p 4.

for the major retailers to use their market power to push costs, risks and responsibilities back down the supply chain."[3]

"Growers are price takers and not price setters. Transparency, competition and fairness through the supply chain must be addressed, in order to ensure that the farm sector, as price takers, does not incur the major impacts of any price reductions at the retail end of the chain."[4]

The view from the farmers' perspective is that they are obliged to take whatever price is imposed by the large supermarket chains, wholesale agents, processors and world markets. In contrast, the view taken by the Australian National Retailers Association is that these potential markets for Australian produce reduce the prospect of supermarkets having market power, as these options combine with increasing demand, prolonged drought and reduced subsidies to increase food prices.

It is not clear to Coles why farmers and growers associations have not sought to use the collective bargaining provisions under the Act to supply domestic purchasers. Coles experience is that the more sophisticated growers recognise these opportunities and are taking them to the market in that way.

From Coles perspective we recognise that growers do have options and will increasingly develop them. While Coles considers that it has good relationships with the vast majority of its suppliers, Coles recognises these options and seeks to ensure we are an attractive buyer to deal with. Coles also recognises the fact that it provides many of its smaller suppliers with greater certainty regarding retail volumes and continuity of supply than may be provided by these alternative supply options. Coles has relationships with many suppliers going back over 20 years.

Coles also notes that world food prices are increasing due to global shortages. This trend is likely to increasingly provide suppliers with more options and this will only strengthen the position of suppliers as demand increases. In these situations, Coles' objective is to ensure long-term sustainability and continuity of supply and it works with suppliers to achieve this.

Coles also notes that the price it pays for goods is only one, albeit important, part of its relationship with suppliers. Coles also ensures suppliers can secure adequate volumes for their products, providing economies of scale to suppliers and additional security of supply. Coles also provides this scale opportunity where it is able to source its private label needs from small local suppliers. In addition, Coles provides suppliers with broad geographic coverage, participation in advertising in Coles' catalogue, information about the performance of their products and prompt payment in line with agreed time frames.

Many products sourced from smaller suppliers are vital to Coles providing a range of product to its customers in varying price categories.

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3 Queensland Farmers Federation, *Grocery Prices Inquiry - Submission* (11 March 2008) at p 1.

4 Victorian Farmers Federation, *Submission to ACCC Inquiry into the competitiveness of retail prices for standard groceries* (13 March 2008) at p 3.

For example, many speciality foods (eg Asian foods) and health food categories are supplied primarily by small suppliers. These categories are a critical part of Coles' offering to its customers, with speciality foods being located to match demographics.

As noted above, there may also be opportunities for Coles' smaller suppliers to enter into collective bargaining arrangements to negotiate the terms of supply (including price) with Coles. Small suppliers of produce have previously lodged collective bargaining notifications with the Commission or sought authorisations when proposing to collectively negotiate the price and quantity of their supply of produce to buyers, including supermarkets, processors and wholesalers.

Coles notes that the collective bargaining notice process has only been in force since 1 January 2007. It appears likely that the full impact of this new process in changing the respective bargaining positions of supermarkets and smaller suppliers is yet to be fully felt. Coles is generally supportive of these arrangements.

3.3 Contract terms/terms of supply

Coles endeavours to enter into written standard Terms and Conditions of Supply with suppliers which set out the terms and conditions on which goods are supplied to Coles. If a supplier wishes to vary any aspect of these terms and conditions, they may be negotiated with Coles and the parties will arrive at a mutually agreed position.

Coles' standard Terms and Conditions of Supply operate in conjunction with Trading Terms and Housebrand Agreements entered into with suppliers.

Trading Terms are negotiated between Coles and suppliers for both proprietary and housebrand product to record the commercial terms of their supply arrangement (eg fees, rebates, payment terms). Housebrand Agreements are negotiated with suppliers for set periods. Once a Housebrand Agreement has expired, a tender is run to allocate the new business. A tender is issued with product specifications, delivery requirements, estimated volumes and supply terms and conditions.

If a supplier does not comply with its contractual arrangements with Coles, it may form grounds for Coles to terminate the supplier relationship (eg where there are issues of food safety or continued problems with stock availability).

Perishable Goods

There is some variation to the contract procedures described above in relation to perishable goods (eg fruit and vegetables, meat). Some arrangements are captured in written agreements and are long term. Other arrangements are short term or not reduced to formal contractual form (for example, Coles arrangements for the supply of fresh fruit from wholesale markets and growers are negotiated and agreed on a weekly basis).

Coles also has arrangements that incorporate a mix of long term and short term elements, such as its arrangements for the supply of vegetables whereby Coles has ongoing agreements in place with vegetable packing sheds and

agrees to acquire a certain percentage of growers' crops with the price negotiated weekly.

3.4 Complaints handling processes

Coles' standard Terms and Conditions of Supply require parties to use their reasonable endeavours to resolve a dispute through a dispute resolution process. In practical terms, this means that:

- if a dispute arises, there are internal and external avenues where suppliers can raise their grievances. Internal avenues available to suppliers include the automated grievance lodgment process located on the Coles Supplier website, direct engagement with the buying party or supermarkets management as required;

- if the dispute cannot be resolved through consultation between the parties, suppliers can access the services of the alternative dispute resolution scheme adopted in 2000 under the Produce and Grocery Industry Code (formerly the Retail Grocery Industry Code of Conduct). This provides Coles' suppliers with access to an independent Ombudsman who can review their grievance and, if needed, order mediation between the supplier and Coles at no expense to the supplier; and

- where the dispute remains unsettled, the independent Ombudsman can make a determination in favour of one or other party. In the seven years the scheme has been operating, no matter involving Coles has resulted in a determination.

3.5 Allegations in relation to discrepancy in supplier terms

During the Inquiry, there have been allegations that Coles and Woolworths receive better terms from suppliers than independent retailers, creating a so-called "waterbed" effect on convenience store owners.[5] If this effect existed, it would involve Coles and Woolworths obtaining allegedly favourable terms from suppliers resulting in suppliers increasing the prices they charge to other grocery retailers.

Coles cannot comment in detail on the terms provided by suppliers to other retailers. However, it believes that the price it pays for goods into its distribution centres and direct into retail stores are comparable to those available to other supermarket chains and wholesalers.[6] Discounts and rebates offered by suppliers are influenced by sales volumes and, while confidential, are believed to be similar. They are also generally dependent on retailer/wholesaler performance in settlement days and the provision of marketing support in ranging, layouts and promotions.

Coles further notes that this issue was considered by the UK Competition Commission, which found no evidence of a "waterbed" effect.[7] It instead

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5 National Association of Retail Grocers of Australia, *Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries* (14 March 2008) at p 13.

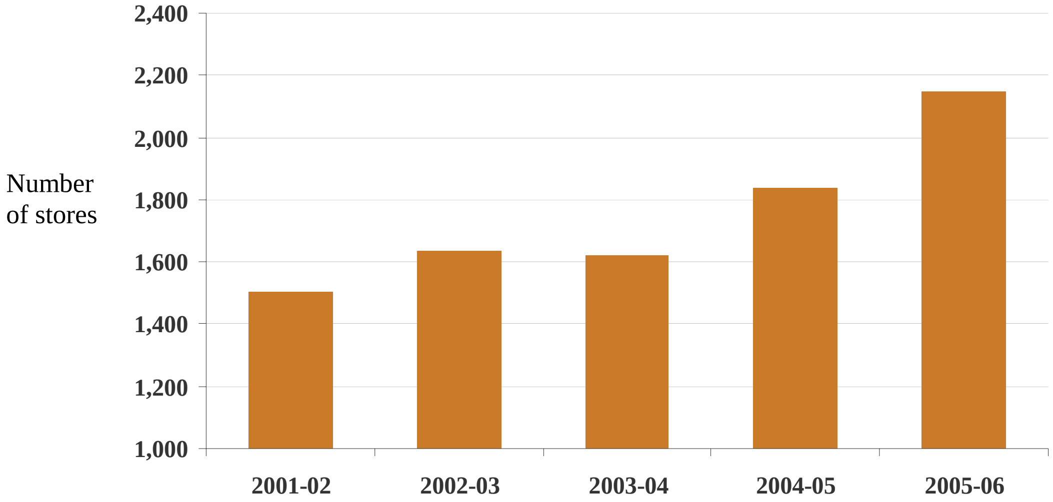
6 ACCC Report on Trading Terms 2002

7 UK Competition Commission, *The supply of groceries in the UK market investigation final report - appendix 5.4: the waterbed effect in supplier pricing* (30 April 2008) at [48], [49], [58], [59].

suggested that differences in supplier prices may be explained, at least in part, by the economy of scale benefits the suppliers gain from supplying larger customers.

The UK Competition Commission observed that a "waterbed" effect would need to be evidenced by an unambiguous decline in convenience store numbers and revenues.

As is the position in the UK, convenience store growth in Australia is dynamic - not decreasing. The following chart shows the rapid growth in convenience stores that took place between 2001 and 2006.



Source: IBISWorld 2007 (G5112 – Convenience stores in Australia)

3.6 Rejection of fresh produce

In relation to fresh produce, Coles considers its level of rejections is very low. Rejection is typically on the grounds of failure to meet specifications, blight or temperature-induced damage.

Coles' standard Terms and Conditions of Supply state that Coles may reject goods at any time before "acceptance" if they do not meet specified requirements. Coles is deemed to have accepted goods once it has had a reasonable time to inspect them following delivery or within a reasonable time after any latent defect has become apparent.

The steps that Coles takes when rejecting produce are:

- Coles assesses the quality of produce upon its receipt at a distribution centre, by comparing a representative sample of produce with the relevant product specification and completes a written assessment;

- if the produce is not of suitable quality, Coles will complete a rejection notice, which it will send to the relevant buyer, together with the completed assessment;

- copies of the assessment and rejection notices are sent to the supplier, who is given the opportunity to provide an explanation or to comment on the rejection notice via e-mail; and

- digital photos of rejected stock are taken where issues may arise and are forwarded to the buyer and supplier, where appropriate.

Following a rejection, the volume of product bought from the supplier may be adjusted, although on occasion a buyer may override the rejection notice, for example if the damage is merely cosmetic in nature. In this case the cost of the produce may be immediately renegotiated with the supplier. The supplier will be responsible for the removal of rejected stock at its own cost.

Temperature-controlled produce can often conceal signs of poor quality until it is moved from cold storage to storage at ambient temperature. For this reason, temperature-controlled produce can be rejected after a longer period, depending on the transport stage at which the problem is identified and up to a maximum of 48 hours from receipt at the distribution centre (subject to negotiations). This 48 hour period consists of 24 hours for the distribution centre to reject stock once it has reached ambient temperature and 24 hours for stores to perform a final quality check.

The relevant buyer can choose to absorb the cost of minor volume product rejections rather than impose the cost on the supplier. For example, if only 10 cartons of stock are returned to the distribution centre from stores, this would be deemed "buyer cost" and generally absorbed by Coles. On the other hand, if 120 cartons were returned, the buyer would inform the supplier in order to obtain credit for the rejected stock.

3.7 Cost savings and pass through to customers

Coles notes allegations that major supermarkets extract lower prices from suppliers without passing those savings on to consumers. Coles does not believe these allegations have been supported by credible evidence. It also notes that, if this were true, it would effectively mean that the supermarkets were extracting monopoly rents from suppliers. Coles again refers to the relatively thin margins on which it (and other supermarkets, both in Australia and overseas) operates, which do not support any such proposition.

Rather, as noted above, the cost of food has been increasing globally. Inevitably, these increases in food prices have to be borne by one or more of the participants in the supply chain, who are in general terms the supplier, the retailer or the consumer (while other parties, such as processors, may also be present in the supply chain, they will vary by product). The proportion in which each participant bears the costs will depend on a number of factors, including how consumer demand responds to price increases, the reason for the cost increase, the likely duration of the cost increase, the price sensitivity of the product from a consumer perspective and the existing margin on the product.

The supplier perspective that supermarkets are charging more to consumers and must therefore be increasing their margins is flawed for a number of reasons. In particular, supermarkets have a number of other costs which arise between the farm gate and the shopping basket. Some of these costs, such as

the increasing cost of freight, are significant costs for most products. Others will vary substantially by product, such as:

- Meat: Coles experiences significant yield losses in transformation of carcases into saleable meat products. For example, a beef carcase will yield several different cuts of beef which can be ranged in a supermarket, but it will also yield some by-products which go to other, lower margin, uses. Some parts of the carcase will simply be wasted.

- Fruit and vegetables: Between the farm and the supermarket there are substantial losses in volume. These may arise from:

  - initial grading for split, misshapen, immature, or oversized items;

  - packing shed grading and further processing waste;

  - retail shrinkage including loss of weight, handling spoilage and deterioration due to age or storage impact;

  - loss of volumes in processing fruit and vegetables for packaged and processed products; and

  - non compliance with specifications, for example in relation to size, colour, blemishes, breakdown (product defects – mould), condition defects (puncture wound on fruit/vegetable skin or a disease fungal that will continue to deteriorate the product), brix levels (measure of soluble solids) and pressure testing (specific unit of measure – kilos per square metre).

As well as sourcing fruit and vegetables direct from growers, Coles uses “aggregators” to source a substantial amount of its fresh produce. The aggregators deal with the growers to source fresh produce and on-sell it to Coles. Coles is working more directly with growers and, in some cases, this will mean no longer using “aggregators”. This will see Coles taking ownership of produce on delivery to the distribution centre. These changes are driven by Coles’ need to plan and secure larger volumes of produce which meet Coles’ quality specifications and to reduce the costs associated with the use of agents. As part of this change, stock delivered to two Fresh Produce distribution centres is now owned by Coles and are no longer aligned to the service provider.

The intention behind this change is to develop, in conjunction with growers, a growing program that will deliver the volume tonnage required to service the supermarkets business. Coles currently intends to provide an initial expression of interest to give the grower an indicative cost pre-season. As product becomes available, it is intended that the Coles buyer will negotiate the best price on a weekly basis, also taking into account seasonal impacts (for example, if there is a glut of produce and it is a good season, then prices may need to decrease to remain compelling for consumers). Growers and Coles have a common interest in maintaining sales volumes. This will provide an opportunity to improve the transparency of payment, with Coles paying suppliers directly rather than through the service provider.

3.8 Horticulture Code of Conduct in relation to Central Markets

Coles notes the new Horticulture Code which came into effect on 14 May 2007 incorporates transparent trading terms and dispute resolution procedures that mirror those under the Produce and Grocery Industry Code (**PAGIC**). Coles believes these procedures should be a valuable tool to settle disputes arising in the context of wholesale fresh produce markets. In particular:

- PAGIC arose out of the 1999 joint parliamentary inquiry and applies to the whole supply chain of the retail grocery industry, not just to the horticulture sector;
- the Horticulture Code was set up to ensure that written documentation was entered into at the first point of transacting at central markets between growers and market traders (i.e. those trading either as wholesalers or as merchants or as both);
- Coles buys approximately 85% of its fresh produce directly from growers and pack houses or consolidators of fruit and vegetables and these transactions are transparent and clear with seasonal purchase contracts including price mechanisms. This approach provides Coles growers with the certainty they need when planting crops and planning production because the grower will know in advance the agreed volumes, payment terms, prices to be paid and produce specifications;
- since the PAGIC was introduced in 2000, there have only been three occasions where disputes with horticultural growers were escalated to the Ombudsman and they were all resolved to the satisfaction of the growers and Coles;
- Coles notes that the submission by the Horticulture Code review committee to the Inquiry stated that it was outside the Committee's terms of reference to discuss whether the code should be extended to cover other sectors of the market;
- given Coles already has transparent terms of trade regardless of whether product is directly sourced from growers or from wholesaler/agents and there have been only three complaints to the PAGIC Ombudsman, Coles believes it is unnecessary for the Horticulture Code to be extended nor should it duplicate the PAGIC. Coles notes that market wholesalers and agents are also covered by the PAGIC and growers can also register unresolved disputes with market agents and wholesalers with the Ombudsman;
- Coles notes that the Horticulture Code Issues Paper released by the Commission raises a question regarding the role of the retailers' agents and consolidators and whether these transactions should be covered by the Horticulture Code. Coles advises that it is currently making changes to this particular fresh produce sourcing method (as mentioned briefly above) which will be more fully detailed in the forthcoming submission.

3.9 Promotional activity costs

Contrary to some assertions, Coles does not consider that it charges 'slotting fees' to suppliers in order for them to access shelf space [8]. Coles has already provided information to the Commission regarding its product ranging arrangements, including new product promotional activity arrangements.

Coles wants the products sold in its stores to be successful. Given that every product stocked by Coles occupies space that could be used to stock a different product, the choice of one product over another represents an opportunity cost to Coles. Consequently, Coles needs a compelling reason to stock that product, generally in the form of a reasonable degree of certainty that sufficient volumes of the product will be sold.

Marketing and promotional activity is therefore needed to ensure the viability of a new product and this cost is jointly borne by suppliers and Coles. Other promotional activities and non-standard ranging arrangements also involve costs to Coles and may include both actual expenses and opportunity costs.

It has been alleged that supermarkets actively manage shelf placement and promotional offers. Coles confirms that it does actively manage its store layouts and ranging. It ought not to surprise the Commission or suppliers that prominence is given to the best performing lines. However, Coles does not agree with the contention that this necessarily disadvantages small suppliers. Rather, it disadvantages brands which do not perform to requirements.

3.10 Product management and deletions

In order to remain relevant to customer needs, Coles assesses its range on a continuous basis via annual category reviews. During the review, the performance of all products in the range is considered using the following criteria. In response to the Commission's informal request for category margin data, Coles stated that category average margins are generally considered by Coles buyers as part of the range review process. This review process typically involves consideration of a number of different factors including:

- customer needs;
- sales potential;
- product costs through supply chain and at store;
- product differentiation;
- product attributes (including packaging);
- role in the category;
- range gaps;

[8] Australian United Retailers Ltd (FoodWorks), *Public submission to ACCC grocery inquiry* (11 March 2008) at p 34; National Association of Retail Grocers of Australia, *Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries* (14 March 2008) at pp 4, 65.

- marketing activity support;
- internal category budget expectations.

Deletions that take place may also be initiated by the supplier, for example because of a pack size change or because it is deleting a product.

Any product can be removed from Coles' range if it does not meet the performance criteria, regardless of any trading agreements that have been reached on the item. This is a necessary aspect of managing a customer focused retail business as it ensures that the items that customers most want are ranged.

3.11 Previous inquiries and views on treatment of suppliers

As the Commission is aware, there have been several reports and inquiries related to competition policy over the past 10 years that have application to the retailing sector including:

- the 1999 "Fair Market or Market Failure" Parliamentary Inquiry into the grocery retailing industry;
- the 2002 Report to the Senate by the Commission on prices paid to suppliers by retailers in the Australian grocery industry;
- the 2003 Review of the Competition Provisions of the Trade Practices Act;
- the 2004 Report by the Commission assessing shopper docket petrol discounts and acquisitions in the petrol and grocery sectors; and
- the 2004 Senate Economics Reference Committee Report into the effectiveness of the Trade Practices Act 1974 in protecting small business.

In general terms, although some of these Reports suggested some changes to the Act, or introduction of various industry Codes, the themes that emerged from these reports are that:

(a) the Act should protect the competitive process, not particular competitors or less competitive businesses;

(b) the competition provisions of the Act should not be used to implement industry policy; and

(c) there was no evidence of systemic breaches of the Act by large players in the retailing sector.

Coles also notes that negotiating what may be considered to be a 'hard bargain' or otherwise engaging in aggressive competition is not in and of itself evidence of unconscionable conduct. As the Commission will be aware, the courts have stated that:

> "*When assessing particular conduct and particular circumstances, [it is helpful to keep in mind] that if there is a scale by which to measure*

unreasonable behaviour by one person towards another, unconscionability is towards the extreme end of that scale"[9].

It is also important to note that the assessment of unconscionable conduct is very much a case by case analysis and much depends on the individual circumstances of the particular supplier. The courts have also supported the ability of businesses such as Coles to terminate relationships with suppliers where trust and confidence has been undermined[10].

Coles considers that these findings remain relevant today and that its day to day dealings with suppliers do not involve systemic breaches of the Act. Coles believes that its supplier terms are generally:

- reasonably necessary for the protection of Coles' legitimate business interests;
- the subject of negotiation with suppliers;
- consistent with other transactions involving similar suppliers; and
- reflective of the terms of which the supplier could have supplied identical or equivalent goods to another person.

3.12 Compliance

Coles has a mandatory fair trading compliance training program in place which merchandise team members are required to complete if they are new to the team or if a module to the program is updated. In addition, if it is recognised that a compliance issue exists in relation to a particular team member, that individual may be asked to complete a part of the training as a refresher.

The program provides team members with a relevant overview of fair trading, its key elements and the consequences of non compliance. In general, it aims to build competence in fair trading issues that directly impact a team member's level of responsibility. The training is also complemented with one on one facilitation by "subject matter experts" as required.

9 *Australian Competition and Consumer Commission v Samton Holdings Pty Ltd* [2000] FCA 1725 at [83].

10 *Garry Rogers Motors (Aust) Pty Ltd v Subaru (Aust) Pty Ltd & Anor* (1999) ATPR 41-703 at p 43,016.

4 Section Four - Access to suitable sites and barriers to entry

4.1 Introduction

Several public submissions made to the Commission have commented on the difficulties faced by independent grocery retailers in gaining access to suitable sites for the establishment of new grocery stores. The submissions have focussed on the following issues, which are alleged to give rise to entry barriers:

(a) the existence of lease arrangements between shopping centre landlords and major supermarket chains which restrict the ability of independent retailers to gain access to suitable sites;

(b) the practice of “land banking” by major supermarket chains and its impact on the ability of independent retailers to gain access to suitable sites; and

(c) the impact of local planning and zoning restrictions on the ability of independent retailers to gain access to suitable sites.

Coles makes the following comments in respect of these allegations.

4.2 Access to suitable sites is driven by factors outside of the control of major chains

Some grocery retailers have submitted that it is difficult to obtain suitable sites within major shopping centres. Coles notes, however, that these difficulties are not unique to new or independent grocery retailers. Coles has itself experienced difficulty in obtaining access to suitable sites, for example as a result of:

- the existence of intense competition to lease or acquire the sites that Coles considers to be best suited to operating a supermarket business. Depending on the size and location of the site, Coles faces competition not only from grocery retailers such as Woolworths, Aldi, IGA and Franklins, but also from a substantial number of non-grocery retailers whose retail requirements equally suit such sites. Landlords are accordingly able to choose freely between suitable tenants;

- the preferences of landlords. Landlords may prefer to lease a site to a non-grocery retailer for a variety of reasons, including to preserve the desired retail mix of a shopping centre, or for future planning and development of the site; and

- an inability under local planning schemes, or because of multiple adjacent ownerships, for landlords to increase the size of a site to accommodate more retail space.

A number of public submissions have also alleged that landlords often favour major supermarket chains over independent retailers in the supply of retail space in major shopping centres.[11]

The decision as to whether to supply retail space to a particular retailer is ultimately a commercial decision to be made by shopping centre landlords.

Examples:

Coles understands that landlords may prefer to offer retail space to major supermarket chains for the following legitimate commercial reasons:

(a) major supermarket chains are established retailers with a strong track record of performance and meeting rental obligations;

(b) leasing retail space to a major supermarket chain may result in an increase in the value of the shopping centre concerned (as centres anchored by major supermarket chains and discount department stores can trade at a better yield than those tenanted by other operators) - known as the 'value of the lease covenant'; and

(c) for shopping centres owned by highly leveraged syndicates or other non-direct ownership vehicles in particular, the constitution or internal policy of the ownership vehicle may only allow a small proportion of the space to be allocated to 'non major' retail chains.

4.3 Restrictive covenants in lease arrangements are driven by commercial factors

A number of the submissions made to the Commission allege that the difficulties in gaining access to suitable sites result from restrictive covenants contained in leases between landlords and major supermarket chains.[12]

Coles acknowledges that many (although fewer than half) of its commercial leases contain what are known as "second tenancy" clauses. These clauses generally indicate that Coles has accepted the terms of the lease in reliance upon representations by the landlord that it will not include another supermarket of a certain size (typically either 500m² or above or 1000m² or above) within the centre for a period of time (usually between 5 and 10 years). If the landlord seeks to include another supermarket within the centre during that time, there may be a decrease in rental payable by Coles for the whole or a proportion of the lease term after the new supermarket has opened, often based on the impact on turnover.

Lease agreements contain many different clauses which strike a balance between the respective interests of the landlord and Coles. Examples of clauses which may restrict Coles include restrictions on what Coles is

[11] Australian United Retailers Ltd (FoodWorks*), Public submission to ACCC grocery inquiry* (11 March 2008) at p 34; National Association of Retail Grocers of Australia, *Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries* (14 March 2008) at p 29; Metcash Ltd, *Public submission to the ACCC grocery inquiry* (11 April 2008) at p 34.

[12] Australian United Retailers Ltd (FoodWorks), Public submission to ACCC grocery inquiry (11 March 2008) at p 34; National Association of Retail Grocers of Australia, Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries (14 March 2008) at p 29; Metcash Ltd, Public submission to the ACCC grocery inquiry (11 April 2008) at pp 2, 33.

permitted to sell, signage restrictions and restrictions on assignment. As such, Coles considers that such second tenancy clauses must be viewed within their commercial context. It can take between 1 and 5 years for a supermarket to establish trade in a new location and achieve reasonable profitability. Prior to entering into a lease, Coles conducts an economic assessment as to the viability of the site, including the amount of rent and the other commercial terms (including share of outgoings payments, turnover rental and sales thresholds) which would be needed for the site to deliver a satisfactory return for shareholders. Factors such as the design of the centre, location and ratio of car parking, provision of adequate signage, and the balance of the leasing mix are also taken into account by Coles when making this assessment.

In leases for a new or emerging location, Coles generally expects that, within the first 3 to 5 years, the ratio of rent to sales will be higher than is considered sustainable in the long term, although it would be expected that these ratios would improve over time. As rent reviews under the terms of Coles' leases occur on average every 5 years, Coles will often seek to have a second tenancy clause inserted into a lease to provide the new store with an opportunity to establish trade and create a degree of certainty over Coles' expected return on investment in the short term.

Where a developer insists on another supermarket or large grocery offer, Coles will adjust its assessment of the site's viability and its sales expectations and the affordability of the proposed rental payments will be modified accordingly. Coles considers this to be a legitimate commercial business practice aimed at ensuring the overall viability of Coles' investment in the relevant site.

Conclusion:

A lease represents the outcome of a negotiation, which has reached a commercial balance between protection of both the lessor and the lessee. For example in most Coles leases, the restriction on change of control of the lessee, the limit on the area available for subleasing, and the strict definition of the permitted use for the store each protect the landlord and significantly reduce Coles' options for exiting underperforming stores. Given Coles typically enters into leases for between 15 and 20 years and acts as an anchor tenant for most shopping centres where it is present, Coles needs to balance these factors against its long term investment needs.

4.4 Site/property acquisition practices

Public submissions to the Commission have also alleged that the major supermarket chains engage in "land banking" or other defensive property acquisition practices. Coles denies that it engages in the conduct described in these submissions.

"Land banking"

It has been alleged that the development of suitable retail sites in some areas is constrained by the major supermarket chains engaging in "land banking". This practice, as described in the submissions, involves a market participant

buying land without an actual intention to develop that land in order to avoid development by competitors.

"Landbanking" of the type contemplated by the Inquiry is more likely to be undertaken by landlords of existing retail property in order to protect their existing investment. Although Coles is not privy to the specific property acquisition strategies of shopping centre landlords, it considers that it would be rare that a landlord would acquire land purely for defensive purposes, not least because this would typically be an inefficient use of capital. Most large shopping centres have grown by adjacent acquisition and landlords are more likely to acquire adjacent land for the purposes of securing land for future growth in concert with local planning schemes. Indeed, many local planning schemes encourage this activity by designating future retail growth in areas already occupied by shopping centres.

Acquisition of shopping centres by Coles

A number of the public submissions allege that there is an emerging pattern of the major supermarket chains buying shopping centres where they do not have an existing presence. It is alleged that this will allow Coles and Woolworths to establish their own new supermarkets by refusing to renew the leases with existing supermarket operators.

Coles does not and has not owned a significant number of supermarkets where it has replaced an independent retailer. Coles considers that this issue has been significantly overstated in terms of the implications for competition within the grocery industry.

"Creeping" acquisitions

It has also been alleged that Coles has undertaken "creeping acquisitions" of dozens of large independent grocery retailers. Coles confirms that all of its acquisitions of independent supermarkets have been notified to, and assessed by, the Commission.

While arguments have been raised that the Act is not effective against preventing creeping acquisitions, Coles notes that the Commission uses a forward-looking test which may allow the Commission to consider past and current acquisitions when assessing the likely effect of an acquisition on competition.

The Commission's review of Coles' acquisitions in the past suggests that the Commission considers that it currently has the power to prevent harmful creeping acquisitions under the current provisions of the Act. The Commission has not sought to oppose any acquisition of individual stores, or small groups of stores, by Coles. In terms of commentary on these acquisitions there is nothing to outwardly suggest the Commission has had difficulty in analysing local store acquisitions[13]. This statistic seems to support the view that no creeping acquisitions in the grocery sector to date would be likely to have the effect of lessening competition substantially in a relevant market.

[13] See for example ACCC, Public competition assessment: Woolworths' proposed acquisition of 22 Action stores and development sites (19 October 2005).

The issue of "creeping acquisitions" has previously been considered as part of the 2003 Review of the Competition Provisions of the Trade Practices Act by the Dawson Committee. The Committee considered that:

- caps on the market share that is permitted to be achieved by acquisition would be likely to stifle competition and protect the unsustainable position of inefficient competitors[14];
- the 'declaration' of highly concentrated industries by the Federal Government and a requirement that, once an industry is "declared", acquisitions in that industry be required to be notified to the Commission for review would impact on all mergers occurring in the industry in question, regardless of the merger proponent's market share; and
- section 50 of the Act in its current form is adequate to enable the Commission to consider creeping acquisitions insofar as they may raise competition issues.

Conclusion

Coles also considers that the current prohibition on mergers and acquisitions as contained in section 50 of the Act works effectively in maintaining a healthy competitive environment.

Finally, Coles considers that care needs be taken not to sensationalise the issue of creeping acquisitions. Prohibiting creeping acquisitions may result in the removal of an exit path for independent operators wishing to sell their business and, as noted by the Commission, does not address increases in market shares through organic growth.[15]

Moreover, care needs to be taken not to overlook the consumer in this issue - either in terms of alleged creeping acquisitions or in some of the more unusual suggestions of market share caps. The process of acquisitions, whether at a store or broader level, can lead to a more efficient business operation or better goods and services to a consumer. It would seem unfair and inappropriate to arbitrarily prevent consumers enjoying the benefits of an acquisition of a grocery store where it leads to a preferred outcome for consumers in terms of products or services. If consumers have alternatives (as the current merger test envisages at an individual store level) it is difficult to see that competition is lessened substantially.

4.5 Local planning and zoning restrictions

Several of the public submissions raise concerns that local planning and zoning issues have created a barrier to entry for independent grocery retailers. In particular, the submissions raised the following issues:

[14] The Commission's submission to the Committee also stated that a market cap in the retail sector would be unworkable and would effectively regulate the consumer. In addition, in a regional market, the operation of a market share cap could deny consumers access to the products or services offered by an efficient producer. (*ACCC*, *Submission to the Trade Practices Act review* (June 2002)).

[15] Graeme Samuel, *Competition and the nation's supermarket trolley: a perspective of the ACCC (Speech to the Food and Grocery Council of Australia*) (16 September 2003).

- planning and zoning regulations make it difficult, costly and time consuming for new entrants to obtain suitable sites for stores (in some areas it is difficult to obtain any land at all);

- the approach of federal and local governments is inconsistent;

- current planning and zoning regulations/restrictions are outdated and bear little resemblance to the current commercial environment (that is, areas which have been zoned for retail may no longer be appropriate and viable locations for retail development, and vice-versa); and

- government initiatives to increase the population density in towns and cities has created demand for retail space which cannot be met under existing zoning criteria.

Coles acknowledges that local planning and zoning regulations often make it difficult to gain access to suitable sites for new grocery stores. However, the planning and zoning regulations are difficult for all retailers wishing to obtain suitable sites for stores, not just independent retailers. Coles is certainly not favoured over any other entrant through local council development approval processes.

Coles also agrees that there is currently a shortage of suitable retail zoned land. The desire of planners to concentrate growth in areas around existing sites makes commercial sense, but there is often insufficient retail space which meets the zoning criteria in these areas. The key fault with strategic plans is that they are created at a snapshot in time and rarely move quickly with the changing dynamics of an area. Therefore, retail zoning which may have been appropriate a decade ago for a particular area may no longer be appropriate in light of the current population density and demographics.

Conclusion

Coles considers that the planning and zoning regulatory regime needs to be more consistent, open and visible. The responsibility for approving developments should be retained by local councils, but Coles considers that the responsibility for the development of strategic plans should generally be placed with the State Government, or at a minimum they should have a greater strategic overview. The recent announcements on Principal Activity Centres in Victoria is a good example of this direction.

5 Section Five - Allegations of market dominance

5.1 Introduction - Market definition

Several of the public submissions made to the Commission contain allegations that Coles:

- should determine its market share by reference to specific identified market definitions (for example, by reference to packaged groceries[16], by reference to "groceries, excluding meat, fruit and vegetables"[17] and by reference to "retail groceries"[18]); and
- understates its market share by using a broader market definition than that preferred by the relevant participant.

Coles considers that it is conceptually inappropriate to seek to identify and adopt a sole or definitive market definition as part of the outcomes of the Inquiry where to do so could be taken out of context or used by some to be mischievous. This is because:

(a) alternative market definitions are often put forward by self–interested critics of the major supermarket chains and such definitions typically exclude items such as fresh meat, fresh fruit and vegetables and bakery products. These departments are a core part of Coles' overall product offering; and

(b) more importantly, as the Commission would appreciate, market definition is purely purposive and is used merely as a tool through which to analyse the question of market power and competitive impacts in a given factual circumstances.

Coles' own assessments and identifications of markets and the industries in which it competes vary depending on the reason for conducting the assessment. For example, the view taken by Coles about the competitive landscape in which it operates when determining whether to open a new store or acquire an existing retailer's site is different to that taken when considering its ongoing relationship with a given supplier.

Coles further submits that such internal statements as to "market" need to be considered in the commercial context in which they are used.

Coles does, however, consider several of the market definitions put forward in the public submissions to be unsustainable. Several of the submissions refer, in part, to the Australian Bureau of Statistics ("**ABS**") definitions of the market provided to the Baird Inquiry of 1999. Three measures of the market were suggested by the ABS:

[16] Australian United Retailers Ltd (FoodWorks*), Public submission to ACCC grocery inquiry* (11 March 2008) at p 19; Metcash Ltd, *Public submission to the ACCC grocery inquiry* (11 April 2008) at pp 2, 14.

[17] National Association of Retail Grocers of Australia, *Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries* (14 March 2008) at p 53.

[18] Master Grocers Australia, *Submission by Master Grocers Australia to the ACCC inquiry into the competitiveness of retail prices for standard groceries* (11 March 2008) at p 2; Metcash Ltd, *Public submission to the ACCC grocery inquiry* (11 April 2008) at p 43.

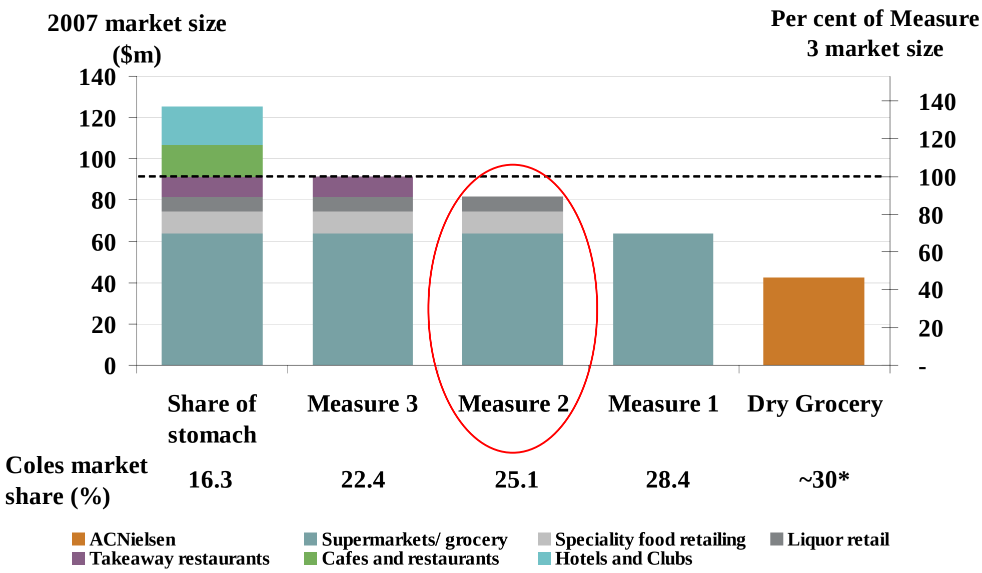
- **Measure 1**: incorporating supermarkets and grocery stores, including non-petrol sales of convenience stores associated with petrol stations. This includes dry grocery and non-dry grocery sales from these retailers.

- **Measure 2**: incorporating all retailers in Measure 1 together with specialised retailing stores (for example, meat, poultry, seafood, fruit and vegetables, bakeries and liquor retailing).

- **Measure 3**: incorporating all retailers in Measure 2 together with take away food retailers.

In addition, Woolworths has previously suggested a broader "share of stomach" definition which includes pubs, clubs and restaurants (ANZSIC classes 4511, 4520 and 4523) whilst NARGA suggest a narrower definition of dry/packaged grocery, based on AC Nielsen scan data. In 1999, AC Nielsen's submission to the Baird Inquiry stated that they felt such a definition was inappropriate. Woolworths, in its submission to the current inquiry, focuses on the number of outlets (versus sales).

The chart below illustrates the size of the market (and hence Coles share) under each definition. The percentage of each measure as a proportion of Measure 3 is shown on the right hand axis e.g. the "dry grocery" definition appears to only include circa 47 percent of the market as defined by measure 3, and within that Coles has a share of circa 30 per cent, representing circa 14 per cent of the Measure 3 market.



Note: ACNielsen scan data does not include significant numbers of non-supermarket chain stores. Coles estimates that the data covers approximately 80 per cent of the market and in that 80 per cent Coles and Woolworths are believed to have an 80 per cent market share between them. Assuming a slightly higher share being held by Woolworths than by Coles implies a market share of circa 30-35 per cent.

Source: ABS cat # 8501.0 Retail Trade, Australia February 2008; ACNielsen; Coles

Coles considers Measure 1 to be too narrow a measure of the industry in which it operates and that, in some instances, Measure 3 would be an appropriate view of the competitive landscape. However, as a working measure, Coles considers Measure 2 to be generally reflective of its competitive environment. This is supported, for example, by Coles pricing policies which involve, in part, Coles conducting local price checks against a wide variety of stores, including speciality food retailers. This is reflective of modern day life and reality where purchase decisions are based as much on convenience or format of the location as on price.

Given the diverse nature of stores which retail perishable products (chains and independent bakeries, butchers, greengrocers etc.) it is difficult to reach a definitive view on Coles' market share of perishables (fresh food excluding dairy). Based on ABS figures, public releases from competitors, and estimates, Coles believes its indicative market share in perishables is around 19-20%.

In any event, and as put by Coles in its earlier submission, regardless of the precise market definition adopted:

- it is the competitive dynamics of the market that are important and, in this case, the market is competitive in all respects, including price, service, innovation and choice. Competition has further been enhanced by the growth of speciality retailers in all major product areas such as Lennard's (poultry), Baker's Delight and Brumbies (bakery), Harris Farm Markets (fresh produce) and multi-store independents such as Drakes (SA) and Ritchie's (Vic) as well as the entry of new competitors such as Aldi and the new Franklins; and

- Coles does not hold market power and is not in a position to misuse any such power for the reasons described below.

5.2 It is market dynamics that count

The High Court has stated that *"the essence of power is absence of constraint. Market power in a supplier is absence of constraint from the conduct of competitors or customers."*[19] Many of the submissions received by the Commission allege use of market power by Coles and Woolworths, ignoring the constraints that Coles faces on a daily basis.

Submissions state for example:

- "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."[20]
- "The large chain stores have significant market power which may allow them to engage in anticompetitive behaviour."[21]
- "Market power has allowed the major retail chains such dominance that there is an effective duopoly operating in this country."[22]

These assertions are not supported by concrete evidence, nor are they supported by a review of Coles' relationships with the three main groups it deals with: customers, suppliers and landlords.

Customers

Coles is focused on its customers. In particular:

(a) Coles' actively competes to win and maintain customers. If Coles were to increase prices to a supra-competitive level or if it were to limit its range or otherwise fail to compete, Coles' customers would shop elsewhere. Most customers have a variety of choices available to them. Further, Coles faces a risk that customers will switch their shopping habits either in whole or in part. For example, some customers would choose to carry out their entire weekly shop at a competitor, such as Woolworths, IGA, Franklins or Aldi, depending on where they live. Alternatively, some customers would reduce their weekly spend at Coles and shop for individual items elsewhere, such as a local greengrocer, baker or butcher;

(b) even in geographic areas where fewer competitors are present, Coles remains constrained by the threat of new entry. If Coles were to increase its prices in a location where the number of competitors is lower than average, it would risk threats of competitor expansion by the likes of Woolworths and Aldi. The threat of new entry would be increased in these circumstances by the likelihood of Council and other support for a new entrant; and

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19 *Boral Besser Masonry Ltd v ACCC* [2003] HCA 5 at [121] (Gleeson CJ and Callinan J).

20 Metcash Ltd, *Public submission to the ACCC grocery inquiry* (11 April 2008) at p 54.

21 Master Grocers Australia, *Submission by Master Grocers Australia to the ACCC inquiry "into the competitiveness of retail prices for standard groceries* (11 March 2008) at p 4.

22 Horticulture Australia Ltd, *Public Submission to the ACCC grocery inquiry by Horticulture Australia Council* (11 March 2008) at p 3.

(c) the growing trend for customers to conduct smaller, more frequent shops makes it easier for them to switch between retailers. It provides customers with greater flexibility as to where they shop and it allows them to shop at different locations.

Suppliers

Coles must treat its suppliers fairly and reasonably to have a long term sustainable business. In particular:

(a) many of Coles' suppliers are large international companies with significant countervailing power and in many cases have far greater financial power than Coles - Australia is a relatively small market - they do not need to sell in Australia if the returns are not acceptable;

(b) there are products and brands that are fundamental to the success of any Australian grocery retailing business. These include products that have no real substitute, such as Vegemite and Gillette razor blades, and those which customers demand despite the existence of substitutes, such as Tim Tams, Sanitarium Weet-Bix and Coca-Cola. Coles cannot afford not to stock these types of products and suppliers are well aware of the power of their brand;

(c) over 95% of fresh items need to be sourced locally for quality, freshness and quarantine reasons. This limits Coles' options with respect to sourcing these items from overseas suppliers and means we must deal with local suppliers - but those local suppliers may be able to sell internationally to many other countries which do not have corresponding quarantine requirements;

(d) some locally sourced produce, such as beef, are produced for export as well as for domestic consumption. Coles is faced with an additional constraint in respect of these products, as suppliers can choose to export a greater proportion of their production if they are unhappy with the terms of supply requested by domestic retailers such as Coles; and

(e) Coles needs security of supply for all products, including proprietary brands, fresh produce and private label in order to provide a consistent and long term comprehensive product offering to its customers.

Landlords

Coles notes that allegations in the public submissions with respect to landlord dealings relate primarily to its competitors' negotiations with landlords. However, Coles may also encounter difficulties in its dealings with landlords. In particular:

(a) Coles often experiences intense competition to acquire what are considered to be the sites most suitable for its business operations. Depending on the size and location of the site, Coles may face competition not only from grocery retailers such as Woolworths, Aldi and Franklins, but also from non-grocery retailers. Landlords may accordingly be able to choose freely between suitable tenants; and

(b) where Coles invests in a site, landlords have the power to undermine that investment by acting contrary to Coles' interests. Coles may be a crucial factor enabling small landlords and developers to secure funding, as the stable income producer of a shopping centre. With long leases and secure, growing income, Coles is then the anchor around which tenancy changes frequently occur, sometimes to Coles' detriment.

5.3 No evidence of market power

Coles does not consider that the allegations of it having market power are supported by evidence. Further, it does not consider that the public submissions contain evidence which contradicts this view.

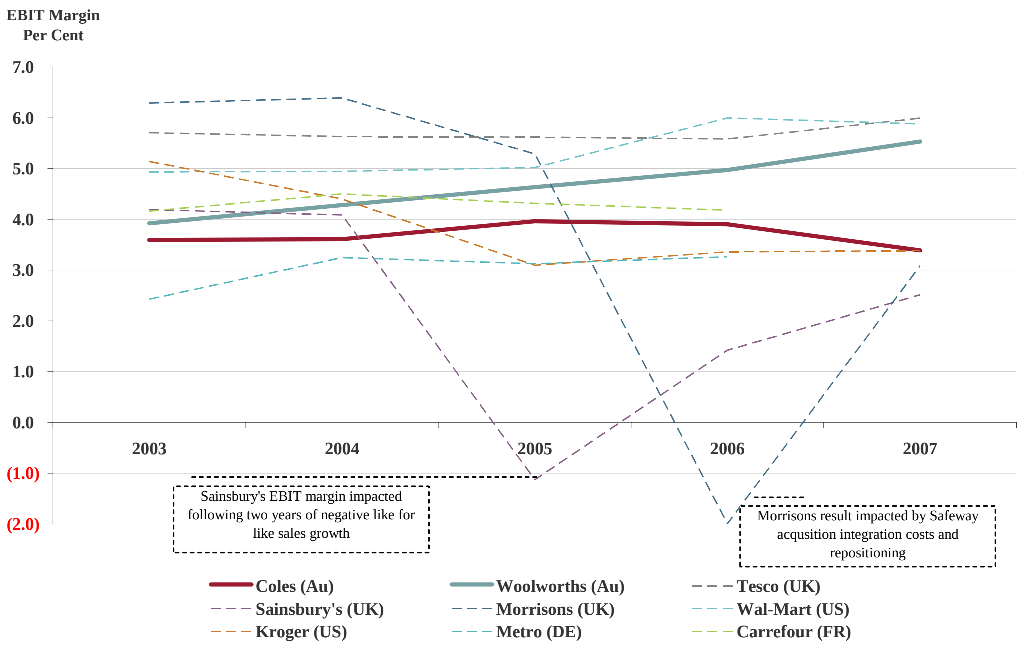
Allegations by competitors

Coles is not surprised that some of its competitors have made allegations regarding the existence and misuse of market power by the major grocery chains. However, in the absence of credible evidence, Coles considers these allegations do not contribute much to an understanding of the competitive dynamics of the industry.

Franklins and FoodWorks comment on the insufficient margins available to retailers to compete with Coles and Woolworths[23]. Coles cannot comment on the profitability of all of its competitors, but it considers that its own margins are within the normal range for retailers. A comparison of Coles' food and liquor EBIT margins over the past five years shows that Coles' average EBIT margin of 3.7% is at the lower end of comparable companies in Europe and the USA.

An EBIT margin of 3.7% does not suggest that Coles is earning excess profits at its competitors' expense and it does not seem consistent with assertions that Coles has market power. Rather, it is consistent with the EBIT margin of a firm operating in a highly competitive industry.

[23] Franklins Pty Ltd*, Response to the ACCC inquiry into the competitiveness of retail prices for standard groceries - volume* 1 (11 March 2008) at p 4; Australian United Retailers Ltd (FoodWorks*), Public submission to ACCC grocery inquiry* (11 March 2008) at p 3.



Source: Woolworths Limited and Coles margins are from their respective operational statistics and are for food and liquor only; all other figures are from Bloomberg and hence are at a group level for each business (i.e. include all geographies and businesses) and are subject to standardisation by Bloomberg

Coles also notes FoodWorks' comments that the independent sector necessarily incurs higher costs and lower margins compared to the vertically integrated supermarkets[24]. Coles accepts that a vertically integrated structure gives rise to efficiencies and cost savings, but considers that this is ultimately beneficial for consumers and is not anti-competitive. It is also worth noting that the independent sector, supplied by Metcash, has increasingly been moving towards realising some of the efficiencies of the vertically integrated model.

Supplier dealings

Coles notes allegations from NARGA that it forces suppliers to engage in price discrimination as between Coles and other retailers[25]. Coles denies that it engages in such conduct. As outlined in section 3.5, Coles believes that the trading terms it has with suppliers are comparable to those available to other supermarket chains and wholesalers.

However, it notes the submission from the Australian Chamber of Fruit and Vegetables that Coles, Woolworths and the independents pay the general wholesale market prices for fruit and vegetables[26].

[24] Australian United Retailers Ltd (FoodWorks*), Public submission to ACCC grocery inquiry* (11 March 2008) at p 18.

[25] National Association of Retail Grocers of Australia, *Public submission part B: ACCC inquiry into the competitiveness of retail prices for standard groceries* (14 March 2008) at p 13.

[26] Australian Chamber of Fruit and Vegetable Industries, *Submission to the ACCC inquiry into the competitiveness of the retail prices for standard groceries* (14 March 2008) at p 5.

5.4 Wholesaling issues

As outlined previously in section 1.3, Coles does not consider itself to be a grocery wholesaler. Wholesale pricing competitiveness is therefore an issue for Metcash, its customers and NARGA.

6 Section Six - Growth of private label products

6.1 Introduction

Several public submissions have commented on the growth of private label products over recent years. Coles understands that this is an area of interest for the Commission, particularly with respect to:

- the impact of private label products on the available range of products and on proprietary brand suppliers;
- the perceived source of supply of private label products (namely, imports, as opposed to domestically produced products); and
- the passing on of price benefits to consumers.

6.2 Private label products enhance customer choice and drive competition between retailers and suppliers

Private label or ‘house brand’ products have been offered to Coles customers since it first commenced supermarket operations in 1960. In 2004, Coles re-positioned and re-labelled its private label brands and currently operates a three-tiered system of house brand products, aimed at increasing the choice available to customers. The three tiers are “Smart Buy” for budget shoppers, “You’ll Love Coles” with mid-range pricing and “Coles Finest” for premium products.

Coles is not the only supermarket to recognise the appeal that private label products have for customers. Woolworths, Franklins and independent banner groups all maintain their own house brand ranges that extend the choice provided by branded products. Many overseas supermarkets also provide house branded products (eg Carrefour, Tesco, Sainsbury, Aldi).

Private label products also have a positive price impact that is clearly pro-consumer.

Customers appreciate the opportunity to purchase essential items without having to indirectly cover the development and marketing costs used to support manufacturers’ proprietary brand products.

Despite its relatively short time in the Australian market and reduced variety of goods on offer, Aldi remains a highly competitive presence with a predominantly house branded product range.

Private label products also allow small and mid-tier suppliers to achieve economies of scale that they otherwise would not have. This acts as a constraint on the prices that major national and international suppliers are able to charge.

The Pricing Section of this submission sets out the pricing policy for each of the "Smart Buy", "You'll Love Coles" and "Coles Finest" product lines. It is clear from this pricing policy that Coles provides consumers with a range of price points and quality, enhancing the competitive offering without simply driving prices down.

Coles also disputes the allegations that private label products have no direct competitive product because they are "exclusive" to the retailer, which means there is no need to offer price reductions as might be the case for a branded product that is readily available in all outlets[27]. The Pricing Policy described earlier in this submission makes it clear that, while Coles' primary aim is to provide keen everyday prices, it also conducts price checks against equivalent competitor and proprietary products.

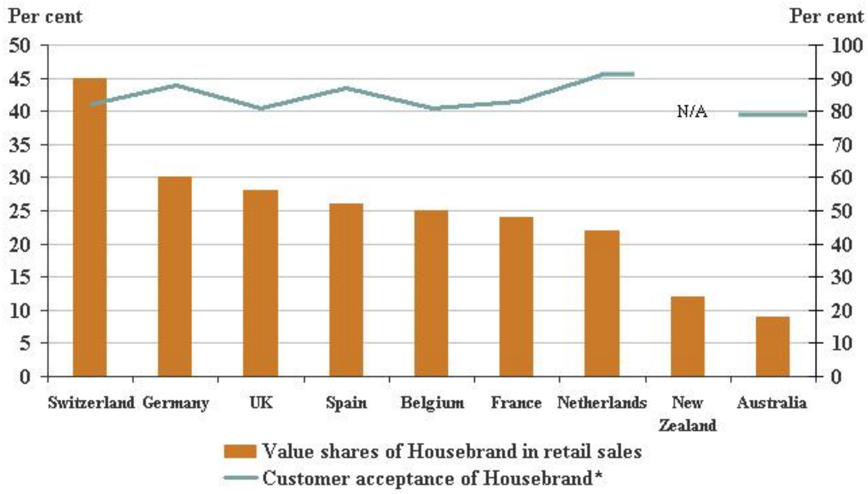
Coles' private label products compete with proprietary brands within Coles stores both directly and in terms of providing alternative value to the customer. Private label products need to offer a better value proposition than proprietary brands which means that the ranges typically provide similar quality products at a lower everyday shelf price throughout the year.

Further, all major retailers, Woolworths, IGA and Aldi, offer private label products so that Coles also has to ensure that its private label products compete with equivalent tiers in those retailers' ranges.

Coles will continue to develop and expand its private label ranges which necessarily involves some degree of competition with proprietary label products. Coles does not view this strategy or the success of its private label ranges as detrimental to competition but, rather, as a strong indication of the need to differentiate to continually provide innovative and price competitive products to meet customer demand and respond to the changing product offerings of Coles' competitors.

It is likely house brand proportions will continue to increase as new products are rolled out. However, Australia has a small percentage of house brands compared to the rest of the world.

[27] Australian United Retailers Ltd (FoodWorks*), Public submission to ACCC grocery inquiry* (11 March 2008) at p 35.



Note: * Percentage of respondents who agreed with the statement "supermarket own brands are a good alternative to other brands"
Source: AC Nielsen "The Power of Private Label", 2005, AC Nielsen "Shopper Trends, 2005; McKinsey

6.3 Financial impacts of private label products

Although private label products produce an increased margin percentage for the retailer, the lower prices paid by consumers mean the margin returns in cents are not necessarily higher.

In addition, depending on relative sales volumes between private label and proprietary brands and the total category sales growth, the overall sales dollars and profit dollars returned could be higher or lower.

Further, pursuit of a private label strategy requires a substantial investment in terms of product and brand development as well as quality management. These costs are mainly fixed and are a necessary cost of market entry. These costs will only be recovered in the longer term through customer acceptance of the products.

The increased relevance of private label products to our customers has also resulted in increased stockholding as a result of longer lead times and the need to maintain consistent product availability for our customers.

6.4 Private label products are not immune from performance management

As shelf-space is finite, Coles conducts periodic reviews of each product category (including its private label products) to ensure that the category is providing appropriate customer choice and also meeting Coles' requirements regarding financial performance. This does mean that, from time to time, proprietary branded products may be removed from the range and/or that private label products are removed from the range.